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SUBCHAPTER A—INCOME TAX (Continued)

PART 2—MARITIME CONSTRUCTION RESERVE FUND

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AUTHORITY: Sec. 511(b), 49 Stat. 1985, as amended, sec. 7805, 68A Stat. 917; 26 U.S.C. 7805, 46 U.S.C. 1161(b).

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EDITORIAL NOTE: The regulations contained in this part have been recodified in 46 CFR part 287.

§ 2.1 Statutory provisions; sections 511 and 905, Merchant Marine Act, 1936, and related statutes.

SEC. 511. [Merchant Marine Act, 1936] (a) When used in this section the term *new vessel* means any vessel (1) documented or agreed with the Commission to be documented under the laws of the United States; (2) constructed in the United States after December 31, 1939, or the construction of which has been financed under titles V or VII of this Act, as amended, or the construction of which has been aided by a mortgage insured under title XI of this Act as amended; and (3) either (A) of such type, size, and speed as the Commission shall determine to be suitable for use on the high seas or Great Lakes in carrying out the purposes of this Act, but not of less than 2,000 gross tons or of less speed than twelve knots, unless the Commission shall determine and certify in each case that a vessel of a specified lesser tonnage or speed is desirable for use by the United States in case of war or national emergency, or (B) constructed to replace a vessel or vessels requisitioned or purchased by the United States.

(b) For the purpose of promoting the construction, reconstruction, reconditioning, or acquisition of vessels, or for other purposes authorized in this section, necessary to carrying out the policy set forth in title I of this Act, any citizen of the United States who is operating a vessel or vessels in the foreign or domestic commerce of the United States or in the fisheries or owns in whole or in part a vessel or vessels being so operated, or who, at the time of purchase or requisition of the vessel by the Government, was operating a vessel or vessels so engaged or owned in whole or in part a vessel or vessels being so operated or had acquired or was having constructed a vessel or vessels for the purpose of operation in such commerce or in the fisheries, may establish a construction reserve fund, for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for other purposes authorized in this section, to be composed of deposits of proceeds from sales of vessels, indemnities on account of losses of vessels, earnings from the operation of vessels documented under the laws of the United States and from services incident thereto, and receipts, in the form of interest or otherwise, with respect to amounts previously deposited. Such construction reserve fund shall be established, maintained, expended, and used in accordance with the provisions of this section and rules or regulations to be prescribed jointly by the Commission and the Secretary of the Treasury.

(c) In the case of the sale or actual or constructive total loss of a vessel, if the taxpayer deposits an amount equal to the net proceeds of the sale or to the net indemnity with respect to the loss in a construction reserve fund established under subsection (b), then—

(1) If the taxpayer so elects in his income-tax return for the taxable year in which the gain was realized, or

(2) In case a vessel is purchased or requisitioned by the United States, or is lost, in any taxable year beginning after December 31, 1939, and the taxpayer receives payment for the vessel so purchased or requisitioned, or receives from the United States indemnity on account of such loss, subsequent to the end of such taxable year, if the taxpayer so elects prior to the expiration of sixty days after the receipt of the payment or indemnity, and in accordance with a form of election to be prescribed by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury,

no gain shall be recognized to the taxpayer in respect of such sale or indemnification in the computation of net income for the purposes of Federal income or excess-profits taxes. If an election is made under subdivision (2) and if computation or recomputation in accordance with this subsection is otherwise allowable but is prevented, on the date of making such election or within six months thereafter, by any statute of limitation, such computation or recomputation nevertheless shall be made notwithstanding such statute if a claim therefor is filed within six months after the date of making such election.

For the purposes of this subsection no amount shall be considered as deposited in a construction reserve fund unless it is deposited within sixty days after it is received by the taxpayer.

As used in this subsection the term *net proceeds* and the term *net indemnity* mean the sum of (1) the adjusted basis of the vessel and (2) the amount of gain which would be recognized to the taxpayer without regard to this subsection.

(d) The basis for determining gain or loss and for depreciation, for the purposes of Federal income or excess profits taxes, of any new vessel constructed, reconstructed, reconditioned, or acquired by the taxpayer, or with respect to which purchase-money indebtedness is liquidated as provided in subsection (g), in whole or in part out of the construction reserve fund shall be reduced by that portion of the deposits in the fund expended in the construction, reconstruction, reconditioning, acquisition, or liquidation of purchase-money indebtedness of the new vessel which represents gain not recognized for tax purposes under subsection (c).

(e) For the purposes of this section, (1) if the net proceeds of a sale or the net indemnity in respect of a loss are deposited in more than one deposit, the amount consisting of the gain shall be considered as first deposited; (2) amounts expended, obligated, or otherwise withdrawn shall be applied against the amounts deposited in the fund in the order of deposit; and (3) if any deposit consists in part of gain not recognized under subsection (c), any expenditure, obligation, or withdrawal applied against such deposit shall be considered to consist of gain in the proportion that the part of the deposit consisting of gain bears to the total amount of the deposit.

(f) With respect to any taxable year, amounts on deposit on the last day of such year in a construction reserve fund in accordance with this section and with respect to which all the requirements of subsection (g) have been satisfied, to the extent that such requirements are applicable as of the last day of said taxable year, shall not constitute an accumulation of earnings or profits within the meaning of section 102 of the Internal Revenue Code [Part I (section 531 and following), Subchapter A, Chapter 1 of the Internal Revenue Code of 1954].

(g) The provisions of subsections (c) and (f) shall apply to any deposit in the construction reserve fund only to the extent that such deposit is expended or obligated for expenditure, in accordance with rules and regulations to be prescribed jointly by the Commission and the Secretary of the Treasury—

(1) Under a contract for the construction or acquisition of a new vessel or vessels (or in the discretion of the Commission, for a part interest therein), or, with the approval of the Commission, for the reconstruction or reconditioning of a new vessel or vessels, entered into within (i) two years from the date of deposit or the date of any extension thereof which may be granted by the Commission pursuant to the provisions of section 511(h), in the case of deposits made prior to the date [July 17, 1952] on which these amendatory provisions become effective, or (ii) three years from the date of such deposit in the case of a deposit made after such effective date, only if under such rules and regulations—

(A) Within such period not less than 12½ per centum of the construction or contract price of the vessel or vessels is paid or irrevocably committed on account thereof and the plans and specifications therefor are approved by the Commission to the extent by it deemed necessary; and

(B) In case of a vessel or vessels not constructed under the provisions of this title or not purchased from the Commission, (i) said construction is completed, within six months from the date of the construction contract, to the extent of not less than 5 per centum thereof (or in case the contract covers more than one vessel, the construction of the first vessel so contracted for is so completed to the extent of not less than 5 per centum) as estimated by the Commission and certified by it to the Secretary of the Treasury, and (ii) all construction under such contract is completed with reasonable dispatch thereafter;

(2) For the liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company

of, or a company affiliated or associated with, the mortgagor on a new vessel or vessels within (i) two years from the date of deposit or the date of any extension thereof which may be granted by the Commission pursuant to the provisions of section 511(h), in the case of deposits made prior to the date [July 17, 1952] on which these amendatory provisions become effective, or (ii) three years from the date of such deposit in the case of a deposit made after such effective date.

(h) The Commission is authorized under rules and regulations to be prescribed jointly by the Secretary of the Treasury and the Commission to grant extensions of the period within which the deposits shall be expended or obligated or within which construction shall have progressed to the extent of 5 per centum of completion as provided herein, but such extension shall not be for an aggregate additional period in excess of two years with respect to the expenditure or obligation of such deposits or more than one year with respect to the progress of such construction: *Provided*, That until January 1, 1965, in addition to the extensions hereinbefore permitted, further extensions may be granted ending not later than December 31, 1965.

(i) Any such deposited gain or portion thereof which is not so expended or obligated within the period provided, or which is otherwise withdrawn before the expiration of such period, or with respect to which the construction has not progressed to the extent of 5 per centum of completion within the period provided, or with respect to which the Commission finds and certifies to the Secretary of the Treasury that, for causes within the control of the taxpayer, the entire construction is not completed with reasonable dispatch, if otherwise taxable income under the law applicable to the taxable year in which such gain was realized, shall be included in the gross income for such taxable year, except for the purpose of the declared value excess-profits tax and the capital stock tax. If any such deposited gain or portion thereof with respect to a deposit made in any taxable year ending on or before June 30, 1945, is so included in gross income for such taxable year, there shall (in addition to any other deficiency) be assessed, collected, and paid in the same manner as if it were a deficiency, an amount equal to 1.1 per centum of the amount of gain so included, such amount being in lieu of any adjustment with respect to the declared value excess-profits tax for such taxable year.

(j) Notwithstanding any other provision of law, any deficiency in tax for any taxable year resulting from the inclusion of any amount in gross income as provided by subsection (i), and the amount to be treated as a deficiency under such subsection in lieu of any adjustment with respect to the declared value excess-profits tax, may be assessed or a proceeding in court for the collection thereof may be begun without assessment, at any time: *Provided, however*, That interest on any such deficiency or amount to be treated as a deficiency shall not begin until the date the deposited gain or portion thereof in question is required under subsection (i) to be included in gross income.

(k) This section shall be applicable to a taxpayer only in respect of sales or indemnifications for losses occurring within a taxable year beginning after December 31, 1939, and only in respect of earnings derived during a taxable year beginning after December 31, 1939.

(l) For the purposes of this section a vessel shall be considered as constructed or acquired by the taxpayer if constructed or acquired by a corporation at a time when the taxpayer owns at least 95 per centum of the total number of shares of each class of stock of the corporation.

(m) The terms used in this section shall have the same meaning as in chapter 1 of the Internal Revenue Code.

(n) The terms *contract for the construction* and *construction contract*, as used in this section, shall include, in the case of a taxpayer who constructs a new vessel in a shipyard owned by such taxpayer, an agreement between such taxpayer and the Commission with respect to such construction and containing provisions deemed necessary or advisable by the Commission to carry out the purposes and policy of this section.

(o) The terms *reconstruction and reconditioning*, as used in this section, shall include the reconstruction, reconditioning, or modernization of a vessel for exclusive use on the Great Lakes, including the St. Lawrence River and Gulf, if the Commission determines that the objectives of this Act will be promoted by such reconstruction, reconditioning, or modernization, and, notwithstanding any other provisions of law, such vessel shall be deemed to be a ''new vessel'' within the meaning of this section for such reconstruction, reconditioning, or modernization.

[Sec. 511 as added by Act of October 10, 1940 (Pub. L. 840, 76th Cong., 54 Stat. 1106), as amended by Act of June 17, 1943 (Pub. L. 78, 78th Cong., 57 Stat. 157); Act of Dec. 23, 1944 (Pub. L. 552, 78th Cong., 58 Stat. 920); secs. 9–14, Act of July 17, 1952 (Pub. L. 586, 82d Cong., 66 Stat. 762); Act of Sept. 12, 1964 (Pub. L. 88–595, 78 Stat. 943)]

SEC. 905. [Merchant Marine Act, 1936.] When used in this Act—

(a) The words *foreign commerce* or *foreign trade* mean commerce or trade between the United States, its Territories or possessions,

or the District of Columbia, and a foreign country.

* * * * *

(c) The words *citizen of the United States* include a corporation, partnership, or association only if it is a citizen of the United States within the meaning of section 2 of the Shipping Act, 1916, as amended (U.S.C., title 46, sec. 802), and with respect to a corporation under title VI of this Act, all directors of the corporation are citizens of the United States, and, in the case of a corporation, partnership, or association operating a vessel on the Great Lakes, or on bays, sounds, rivers, harbors, or inland lakes of the United States the amount of interest required to be owned by a citizen of the United States shall be not less than 75 per centum.

* * * * *

(e) The terms *United States Maritime Commission* and *Commission* shall mean the Secretary of Commerce, the Maritime Administrator, or the * * * [Maritime Subsidy Board] as the context may require * * *.

[Sec. 905 (a), (c), and (e) (49 Stat. 2016), amended by sec. 39 (a) and (b), Act of June 23, 1938 (Pub. L. 705, 75th Cong., 52 Stat. 964); Act of July 17, 1952 (Pub. L. 586, 82d Cong., 66 Stat. 765); sec. 4, Act of Sept. 21, 1959 (Pub. L. 86–327, 73 Stat. 597)]

SEC. 2. [Shipping Act, 1916.] (a) That within the meaning of this Act no corporation, partnership, or association shall be deemed a citizen of the United States unless the controlling interest therein is owned by citizens of the United States, and, in the case of a corporation, unless its president or other chief executive officer and the chairman of its board of directors are citizens of the United States and unless no more of its directors than a minority of the number necessary to constitute a quorum are noncitizens and the corporation itself is organized under the laws of the United States or of a State, Territory, District, or possession thereof, but in the case of a corporation, association, or partnership operating any vessel in the coastwise trade the amount of interest required to be owned by citizens of the United States shall be 75 per centum.

(b) The controlling interest in a corporation shall not be deemed to be owned by citizens of the United States (a) if the title to a majority of the stock thereof is not vested in such citizens free from any trust or fiduciary obligation in favor of any person not a citizen of the United States; or (b) if the majority of the voting power in such corporation is not vested in citizens of the United States; or (c) if through any contract or understanding it is so arranged that the majority of the voting power may be exercised, directly or indirectly, in behalf of any person who is not a citizen of the United States; or (d) if by any other means whatsoever control of the corporation is conferred upon or permitted to be exercised by any person who is not a citizen of the United States.

(c) Seventy-five per centum of the interest in a corporation shall not be deemed to be owned by citizens of the United States (a) if the title to 75 per centum of its stock is not vested in such citizens free from any trust or fiduciary obligation in favor of any person not a citizen of the United States; or (b) if 75 per centum of the voting power in such corporation is not vested in citizens of the United States; or (c) if, through any contract or understanding it is so arranged that more than 25 per centum of the voting power in such corporation may be exercised, directly or indirectly, in behalf of any person who is not a citizen of the United States; or (d) if by any other means whatsoever control of any interest in the corporation in excess of 25 per centum is conferred upon or permitted to be exercised by any person who is not a citizen of the United States.

(d) The provisions of this Act shall apply to receivers and trustees of all persons to whom the Act applies, and to the successors or assignees of such persons.

[Sec. 2 (39 Stat. 729) as amended by Act of July 15, 1918 (Pub. L. 198, 65th Cong., 40 Stat. 900); sec. 38, Merchant Marine Act, 1920 (41 Stat. 1008); sec. 3, Act of Sept. 21, 1959 (Pub. L. 86–327, 73 Stat. 597)]

§ 2.1–1 Definitions.

(a) As used in the regulations in this part, except as otherwise expressly provided—

(1) *Act* means the Merchant Marine Act, 1936, as amended (46 U.S.C. 27).

(2) *Section* means one of the sections of the regulations in this part.

(3) *Administration* means the Maritime Administration of the Department of Commerce as created by Reorganization Plan No. 21 of 1950 (46 U.S.C. 1111 note).

(4) *Citizen* means a person who, if an individual, was born or naturalized as a citizen of the United States or, if other than an individual, meets the requirements of section 905(c) of the Act and section 2 of the Shipping Act, 1916, as amended (46 U.S.C. 802).

(5) *Taxpayer* means a citizen who has established or seeks to establish a construction reserve fund under the provisions of section 511 of the Act and the regulations in this part, and may include a partnership.

(6) *Corporation* includes associations, joint-stock companies and insurance companies.

(7) *Stock* includes the shares in an association, joint-stock company, or insurance company.

(8) *Affiliate* or *associate* means a person directly or indirectly controlling, controlled by, or under common control with, another person.

(9) *Control*, as used in subparagraph (8) of this paragraph, means the possession of the power to direct in any manner the management and policies of a person, and the terms ''controlling'' and ''controlled'' shall have the meanings correlative to the foregoing.

(10) *Person* means an individual, a corporation, a partnership, an association, an estate, a trust, or a company.

(11) *Partnership* includes a syndicate, group, pool, joint venture, or other unincorporated organization.

(12) *Construction*, if so determined by the Administration, shall include reconstruction and reconditioning.

(13) *Reconstruction and reconditioning* shall include the reconstruction, reconditioning, or modernization of a vessel for exclusive use on the Great Lakes, including the Saint Lawrence River and Gulf, if the Administration determines that the objectives of the Act will be promoted by such reconstruction, reconditioning, or modernization, and, notwithstanding any other provisions of law, such vessel shall be deemed to be a ''new vessel'' within the meaning of section 511 of the Act for such reconstruction, reconditioning, or modernization.

(14) *Purchase-money indebtedness* means any indebtedness, or evidence thereof, created as the result of the purchase of a vessel by the taxpayer.

(15) *Contract, contract for the construction*, and *construction contract* shall include, if so determined by the Administration, a contract for reconstruction or reconditioning and shall include, in the case of a taxpayer who constructs a new vessel in a shipyard owned by such taxpayer, an agreement, between such taxpayer and the Administration with respect to such construction, and containing provisions deemed necessary or advisable by the Administration to carry out the purposes and policy of section 511 of the Act.

(b) Insofar as the computation and collection of taxes are concerned, other terms used in the regulations in this part, except as otherwise provided, have the same meaning as in the Internal Revenue Code and the regulations thereunder.

§ 2.1–2 Scope of section 511 of the Act and the regulations in this part.

(a) *Applicability of regulations.* (1) The regulations prescribed in this part—

(i) Apply to gain realized from the sale or loss of vessels, earnings from the operation of vessels, and interest (or otherwise) with respect to amounts previously deposited in the construction reserve fund, for a taxable year beginning after December 31, 1964, and

(ii) Apply to the expenditure, obligation, or withdrawal, during a taxable year beginning after December 31, 1964, of any deposits of gain, earnings, and interest (or otherwise) of the character referred to in subdivision (i) of this subparagraph without regard to the taxable year in which the deposits were made.

(2) As to gain, earnings, or interest (or otherwise) described in subparagraph (1)(i) of this paragraph and as to an expenditure, obligation, or withdrawal described in subparagraph (1)(ii) of this paragraph, the regulations in this part supersede Treasury Decision 5330, as amended (26 CFR (1939) Part 32).

(b) *Nonrecognition and accumulation.* Section 511 of the Act provides, under conditions specified, for the nonrecognition, for income and excess-profits tax purposes, of the gain realized from the sale or indemnification for loss of certain vessels including certain vessels in the course of construction, or shares therein. It also permits the accumulation of the proceeds of such sales or indemnification and of certain earnings without liability under Part I (section 531 and following), Subchapter G, Chapter I of the Internal Revenue Code of 1954, and the regulations thereunder (§§ 1.531–1 through 1.537–3 of this chapter (Income Tax Regulations)).

(c) *Availability of benefits.* The benefits of section 511 of the Act are available to any citizen as defined in paragraph (a)(4) of § 2.1–1, who, during any

taxable year owns, in whole or in part, a vessel or vessels within the scope of § 2.1–3. A citizen operating such a vessel or vessels owned by any other person or persons can derive no benefit from the provisions relating to the nonrecognition of gain from the sale or loss of such vessel or vessels so owned, but may establish a construction reserve fund in which he may deposit earnings from the operation of such vessel or vessels.

(d) *Applicability of section 511.* Section 511 of the Act applies only with respect to sales or losses of vessels within the scope of § 2.1–3 or in respect of earnings derived from the operation of such vessels. A loss to be within section 511 of the Act must be an actual or constructive total loss. Whether there is a total loss, actual or constructive, will be determined by the Administration.

§ 2.1–3 Requirements as to vessel operations.

Section 511 of the Act applies with respect to vessels operated in the foreign or domestic commerce of the United States or in the fisheries of the United States and vessels acquired or being constructed for the purpose of such operation. The foreign commerce of the United States includes commerce or trade between the United States (including the District of Columbia), the territories and possessions which are embraced within the coastwise laws, and a foreign country or other territories and possessions of the United States. The domestic commerce of the United States includes commerce or trade between ports of the United States and its territories and possessions, embraced within the coastwise laws and on inland rivers. The fisheries include the fisheries of the United States and its territories and possessions. Section 511 of the Act does not apply to vessels operated in the foreign commerce or fisheries of any country other than the United States.

§ 2.1–4 Application to establish fund.

Any person claiming to be entitled to the benefits of section 511 of the Act may make application, in writing, to the Administration for permission to establish a construction reserve fund. The application shall be in such form and substance as the Administration may prescribe and shall designate, among other things, the depository or depositories with which the taxpayer proposes to establish the said fund. The original application shall be executed and verified by the taxpayer, or if the taxpayer is a corporation, by one of its principal officers, in triplicate, and shall be accompanied by eight conformed copies when filed with the Administration.

§ 2.1–5 Tentative authorization to establish fund.

Where the time between the receipt by the Administration of the application for permission to establish a construction reserve fund and the date prior to which an amount received from the sale or loss of a vessel must be deposited to come within the scope of section 511 of the Act is insufficient to permit a determination of the eligibility of the applicant, the Administration may tentatively authorize the establishment of a construction reserve fund and the deposit of such amount therein. Such tentative authorization shall be subject to rescission by the Administration if subsequently it is determined that the applicant is not entitled to the benefits of section 511 of the Act, or has not complied with the statutory requirements. For example, a tentative authorization will be rescinded if the Administration ascertains that the applicant is not a citizen. Upon such determination, the fund shall be closed and all amounts on deposit therein shall be withdrawn.

§ 2.1–6 Establishment of fund.

(a) *Authorization by the Administration.* If the application is approved by the Administration, the Administration will adopt Orders authorizing the establishment of a construction reserve fund with the depository or depositories designated by the taxpayer and approved by the Administration. The Orders will provide for joint control by the Administration and the taxpayer over such fund, will set forth the conditions governing the establishment and maintenance of the fund and the making of deposits therein and withdrawals

therefrom, and will designate the representatives authorized to execute instruments of withdrawal on behalf of the Administration.

(b) *Resolution or agreement of the taxpayer.* A certified copy of the Orders of the Administration will be furnished the taxpayer. If the taxpayer is a corporation, it shall promptly adopt, through its board of directors, a resolution satisfactory in form and substance to the Administration, authorizing the establishment and maintenance of the fund in conformity with the action of the Administration. If the taxpayer is not a corporation, it shall promptly execute an agreement with the depository satisfactory in form and substance to the Administration to conform to the action of the Administration as set forth in the Orders. Certified copies of the Orders of the Administration and of the resolution of the taxpayer (if it is a corporation) will be furnished to the depository by the Administration and the taxpayer, respectively, for its guidance in maintaining the fund and honoring instruments of withdrawal. The taxpayer, if a corporation, shall also furnish the Administration with a certified copy of its resolution, or if not a corporation, a duplicate original of its agreement with the depository.

(c) *Constructive action not recognized.* Constructive deposits, substitutions or withdrawals will not be recognized by the Administration in the establishment and maintenance of the fund.

(d) *Failure to make deposits as basis for termination of fund.* In the event no deposit is made into the fund for more than five years, any amounts remaining in the fund shall be removed from the fund at the discretion of the Administration and, if so removed, the fund shall be terminated. In the event of such termination, see § 2.1–23 for recognition of gain.

§ 2.1–7 Circumstances permitting reimbursement from a construction reserve fund.

(a) *Payments prior to establishment of fund.* If, prior to the establishment of a construction reserve fund under the regulations in this part, a taxpayer has made necessary payments under a contract which satisfies the provisions of the regulations in this part and section 511 of the Act for the construction or acquisition of a new vessel, such taxpayer may, if subsequently authorized to establish a construction reserve fund under the regulations in this part, draw against such fund as reimbursement for the amount, if any, of other funds which, with the approval or ratification of the Administration, the taxpayer used for making such necessary payments prior to the establishment of the fund.

(b) *Payments subsequent to establishment of fund.* If, subsequent to the establishment of a construction reserve fund under the regulations in this part, the taxpayer has made necessary payments under a contract which satisfies the provisions of the regulations in this part and section 511 of the Act for the construction or acquisition of a new vessel, such taxpayer may draw against such fund as reimbursement for the amount, if any, of other funds which, with the approval or ratification of the Administration, the taxpayer had used for the purpose of making such necessary payments.

§ 2.1–8 Investment of funds in securities.

(a) *Obligations of or guaranteed by the United States.* Interest-bearing direct obligations of the United States, or obligations fully guaranteed as to principal and interest by the United States, may be deposited in the construction reserve fund in lieu of cash, may be purchased with cash on deposit in the fund, or may be substituted for securities or commitment to finance in the fund, subject to the provisions of paragraph (b) of this section.

(b) *Other securities.* In cases where the taxpayer desires to deposit any securities in the fund in lieu of cash other than those of or guarantees by the United States or to purchase such other securities with cash on deposit in the fund, or to substitute such other securities for securities or commitment to finance in the fund, the taxpayer shall make written application to the Administration and shall not consummate the transaction until the written consent of the Administration shall have been received. The application shall describe the securities fully. Every approval by the Administration

of such application shall be conditioned upon agreement by the taxpayer forthwith to dispose of such securities upon subsequent request by the Administration. Immediately upon the purchase of any securities for deposit in the fund, the taxpayer shall advise the Administration, giving the date of purchase, a description of the securities, and the price paid therefor (net, brokerage and other charges, and gross). Ordinarily, the Administration will not approve the deposit in the fund in lieu of cash, or the purchase with cash on deposit in the fund or the substitution for securities in the fund of securities not actively traded in on exchanges registered under the Securities Exchange Act of 1934 (15 U.S.C. ch. 2B), or securities which are not legal for investment of trust funds. Whenever the Administration approves the substitution of other securities for securities in the fund, such substitution shall be effected only upon or after the deposit of the substituted securities into the fund.

(c) *Cash.* Cash may be substituted for amounts which are on deposit in the fund in any other form.

(d) *Devalued securities.* In the event the Administration determines that the market value at any date of any securities in the fund has decreased to a figure which is less than 90 percent of the market value at the time of deposit into the fund, then within 60 days after the taxpayer receives notice of such determination the taxpayer shall (except as otherwise provided in this paragraph) deposit into the fund cash or securities in an amount equal to the difference between the current market value of the devalued securities and the market value of such securities at the time of their original deposit. However if any securities in the fund are valued at the time of their deposit at less than the market value of such securities at the time of their deposit the taxpayer shall be required to deposit only an amount equal to that portion of the difference between the current market value of the devalued securities and the market value of such securities at the time of their original deposit which bears the same ratio to such total difference as the amount at which the securities were valued at the time of their deposit bears to the market value at the time of such deposit.

§ 2.1–9 Valuation of securities in fund.

(a) *Equivalent values.* In cases where securities are deposited in the fund in lieu of cash, or are purchased with cash on deposit in the fund, or are substituted for securities in the fund, the value of such securities must not be less than the amount of cash in lieu of which they are so deposited or with which they are so purchased, or the value at the time of deposit of the securities for which they were so substituted. If the securities on deposit in the fund are replaced by cash from the general funds of the taxpayer, the amount of cash to be deposited in the fund in lieu thereof shall be not less than the amount at which such securities were valued at the time of their deposit in the fund.

(b) *Determination of value.* (1) For the purpose of determining the amount in the fund, the value of securities shall be their ''market value'' (which shall be the basis for determining value, unless otherwise agreed to by the administration) and shall be determined in the following manner:

(i) In instances where no actual purchase is involved, such as the initial deposit of securities in the fund in lieu of cash, the last sales price thereof on the principal exchange on the day the deposit was made shall be deemed to be the ''market value'' thereof, or, if no such sales were made, the ''market value'' thereof will be determined by the Administration on such basis as it may deem to be fair and reasonable in each case.

(ii) In instances where the purchase of securities with cash on deposit in the fund is involved, ''market value'' shall be the gross price paid (adjusted for accrued interest): *Provided,* That if such securities are purchased otherwise than upon a registered exchange the price shall be within the range of transactions on the exchange on the date of such purchase, or, if there were no such transactions, then the ''market value'' thereof will be determined by the Administration on such basis as it may deem to be fair and reasonable in each case.

(2) Purchase-money obligations secured by mortgages on vessels sold or irrevocable commitments to finance the construction or acquisition of new vessels which are deposited in the construction reserve fund as provided in §2.1–13 ordinarily will be considered as equivalent to their face value.

§2.1–10 Withdrawals from fund.

(a) *Withdrawals for obligations or liquidation.* (1) Checks, drafts, or other instruments of withdrawal to meet obligations under a contract for the construction or acquisition of a new vessel or vessels or for the liquidation of existing or subsequently incurred purchase-money indebtedness, after having been executed by the taxpayer, shall be forwarded to the Administration in Washington, DC, with appropriate explanation of the purpose of the proposed withdrawal, including properly certified invoices or other supporting papers. Such instruments of withdrawal, if payable to the Administration, will be deposited by the Administration for collection, and the proceeds thereof, upon collection, will be credited to the appropriate contract with the Administration; but if drawn to the order of payees other than the Administration, after countersignature on behalf of the Administration, will ordinarily be forwarded to the payees.

(2) An amount obligated under a contract for the construction or acquisition of a new vessel or vessels or for the liquidation of existing or subsequently incurred purchase-money indebtedness, whether the obligor has the entire or a partial interest therein within the scope of section 511 of the Act, may not, so long as the contract or indebtedness continues in full force and effect, be withdrawn except to meet payments due or to become due under such contract or for such liquidation.

(b) *Other withdrawals.* Checks, drafts, or other instruments of withdrawal executed by the taxpayer for purposes other than to meet obligations under a contract for the construction or acquisition of a new vessel or vessels or for the liquidation of existing or subsequently incurred purchase-money indebtedness, whether the taxpayer has the entire or a partial interest therein, shall be drawn by the taxpayer to its own order and forwarded to the Administration in Washington, DC, with appropriate explanation of the purpose of the proposed withdrawal. Such withdrawals may occur by reason of a determination by the Administration that the taxpayer is not entitled to the benefits of section 511 of the Act (see §2.1–5), or that a particular deposit has been improperly made (see §2.1–13), or by reason of the election of the taxpayer to make such withdrawals. Upon receipt of such checks, drafts, or other instruments of withdrawal, the Administration will give notice thereof to the Commissioner of Internal Revenue. The Commissioner will advise the Administration of the receipt of the notice and the date it was received. The Administration shall not countersign such checks, drafts, or other instruments of withdrawal or transmit them to the taxpayer until the expiration of 30 days from the date of receipt of the notice by the Commissioner, unless the Commissioner or such official of the Internal Revenue Service as he may designate for the purpose consents in writing to earlier countersignature by the Administration and transmittal to the taxpayer. Upon the expiration of such 30-day period, or prior thereto if the aforesaid consent of the Commissioner has been obtained, the Administration will countersign the check, draft, or other instrument of withdrawal and forward it to the taxpayer.

(c) *Inapplicability to certain transactions.* The provisions of this section shall not be applicable to transactions deemed to be withdrawals by reason of the sale of securities held in the fund for an amount less than the market value thereof at the time of their deposit (see §2.1–23), nor to the cancellation of an irrevocable commitment deposited in the fund, upon proof satisfactory to the Administration that the terms of such commitment have been fully satisfied.

§2.1–11 Time deposits.

Deposits in the construction reserve fund not invested in securities may be placed in time deposits when, in the judgment of the taxpayer, it is desirable and feasible so to do. The taxpayer

shall promptly advise the Administration of any time deposit arrangements made with the depository. The Administration reserves the right at any time to require the termination or modification of any such arrangements. With prior approval of the Administration a time deposit may be made in a depository other than the one with which the construction reserve fund is established.

§ 2.1–12 Election as to nonrecognition of gain.

(a) *Election requirements.* As a prerequisite to the nonrecognition of gain on the sale or loss of a vessel (or of a part interest therein) for Federal income tax purposes, the taxpayer, after establishing a construction reserve fund, must make an election with respect to such vessel or interest in the manner set forth in this paragraph.

(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the election must be made in the taxpayer's Federal income tax return (or, in the case of a partnership, in the partnership return of income) for the taxable year in which the gain with respect to the sale or loss of the vessel is realized. The election as to the nonrecognition of gain shall be shown by a statement to that effect, submitted as a part of, and attached to, the return. The statement, which need not be on any prescribed form, shall set forth a computation of the amount of the realized gain, the identity of the vessel, the nature and extent of the taxpayer's interest therein, whether such vessel was sold or lost and the date of sale or loss, the full sale price or full amount of indemnity, and the amount and date of each payment thereof, the basis for tax purposes and any other data affecting the determination of the realized gain.

(2) *Certain Government payments.* In case a vessel is purchased or requisitioned by the United States, or is lost, in any taxable year and the taxpayer receives payment for the vessel so purchased or requisitioned, or receives from the United States indemnity on account of such loss, subsequent to the end of such taxable year, the taxpayer shall make his election by filing notice thereof with the Commissioner of Internal Revenue, Washington, DC, 20224, prior to the expiration of 60 days after receipt of the payment or indemnity. The taxpayer shall file a copy of the notice with the Secretary, Federal Maritime Board, Washington, DC, 20573. The form of the notice of election shall be prepared by the taxpayer and shall be substantially as follows:

ELECTION RELATIVE TO NONRECOGNITION OF GAIN UNDER SECTION 511(c)(2), MERCHANT MARINE ACT, 1936

Pursuant to the provisions of section 511(c)(2) of the Merchant Marine Act, 1936, as amended, notice is hereby given that the undersigned taxpayer elects that gain in respect of the sale to the United States, or indemnification received from the United States on account of the loss, of the vessel named below or share therein shall not be recognized. The circumstances involved in the computation of such gain are as follows:

Name and other identification of vessel ____
Nature and extent of the taxpayer's interest in the vessel ____
Nature of disposition, i.e., sale or loss ____
Date of disposition ____
Full sale price or full amount of indemnity received by taxpayer ____
Amount and date of each payment of sale price or indemnity received by taxpayer ____
Amount and date of each previous deposit of such payments in construction reserve fund ____

Identification of each check or other instrument by which payment made to taxpayer ____

Tax basis of taxpayer's interest in vessel ____
Any other data affecting the determination of the realized gain ____
Amount of gain (submit computation) ____

(Name of taxpayer)

By ____

(Date of execution)

§ 2.1–13 Deposit of proceeds of sales or indemnities.

(a) *Manner of deposit.* The deposit required by section 511 of the Act must be made in a construction reserve fund established with a depository or depositories approved by the Administration and subject to the joint control of the Administration and the taxpayer. It is not necessary to establish a separate fund with respect to each vessel or share in a vessel sold or lost.

(b) *Amount of deposit.* With respect to any vessel sold or lost, or a share

therein, the deposit must be in an amount equal to the ''net proceeds'' of the sale, or the ''net indemnity'' for the loss. By ''net proceeds'' and ''net indemnity'' is meant (1) the depositor's interest in the adjusted basis of the vessel plus (2) the amount of gain which would be recognized for tax purposes in the absence of section 511 of the Act. In determining ''net proceeds'', the amount necessarily paid or incurred for brokers' commissions is to be deducted from the gross amount of the sales price. In the event the taxpayer is an affiliate or associate of the buyer, the amount of the sales price shall not exceed the fair market value of the vessel or vessels sold as determined by the Administration. In such case the taxpayer shall furnish evidence sufficient, in the opinion of the Administration, to establish that the sales price is not in excess of the fair market value. In determining ''net indemnity'', the amount necessarily paid or incurred purely for collection, or rate of exchange discounts on the payment, of the indemnity is to be deducted from the gross amount of collectible indemnity. In case of the sale or loss of several vessels or share therein, a deposit of the ''net proceeds'' or ''net indemnity'' with respect to one or more of the vessels or shares is permissible. Where several vessels or shares are sold for a lump sum, the ''net proceeds'' allocated to each vessel or share shall be determined in accordance with any reasonable rule satisfactory to the Commissioner of Internal Revenue. The taxpayer must deposit the full amount of each payment (including cash, notes, or other evidences of indebtedness) as a single deposit in the construction reserve fund. A payment divided between two or more depositories will be regarded as a single deposit. Amounts received by the taxpayer prior to the date of consummation of the sale of the vessel shall be considered as having been received by the taxpayer at the time the sale is consummated.

(c) *Purchase-money obligations.* Where the proceeds from the sale of a vessel include purchase-money obligations, such obligations together with the entire collateral therefor, or, in the case of deposit of the proceeds of a share in the vessel, a proportionate part of the obligations and collateral as determined by the Administration, shall be deposited, with the remainder of the proceeds, in the construction reserve fund as a part of the ''net proceeds''. The depository shall receive payment of all amounts due on such purchase-money obligations and such amounts shall be placed in the fund in substitution for the portion of the obligations paid. All installments of purchase-money obligations shall be paid directly into the fund by the obligor. In the event any such installment is not so deposited, the Administration, at any time after the due date, may require the taxpayer to deposit an amount equal to such installment. If the taxpayer so desires, he may deposit in the construction reserve fund cash or approved securities in an amount equal to the face value of any purchase-money obligations in lieu of depositing such obligations.

(d) *Vessel subject to mortgage at time of sale or loss.* Where a vessel is subject to a mortgage or other encumbrance at the time of its sale or loss and the taxpayer actually receives only an amount representing the equity therein or a share in such equity corresponding to his share in the vessel, he shall deposit in the construction reserve fund such amount and concurrently therewith other funds in an amount equal to the difference between the amount received and the ''net proceeds'' or ''net indemnity''. Such other funds may be in the form of cash, or, subject to the approval of the Administration, (1) interest-bearing securities, or (2) an irrevocable and unconditional commitment to finance the construction or acquisition of a new vessel in whole or in part by an obligor approved by the Administration in an amount equal to the amount by which the ''net proceeds'' exceed the cash or securities deposited in the fund.

(e) *Unauthorized deposits.* A deposit which is not provided for by section 511 of the Act shall, without unreasonable delay, be withdrawn from the fund and tax liability will be determined as though such deposit had not been made. (See §§ 2.1–10 and 2.1–24.)

§ 2.1–14 Deposit of earnings and receipts.

(a) *Earnings.* A citizen may deposit all or any part of earnings derived from the operation, within the scope of § 2.1–3, of a vessel or vessels owned either by himself or any other person, if such earnings are intended for construction or acquisition of new vessels. Such earnings may include payments received by an owner, as compensation for use of his vessel, from other persons by whom it is so operated. Earnings from other sources may not be deposited. The earnings from operation of vessels which are eligible for deposit are the net earnings determined without regard to any deduction for depreciation, obsolescence, or amortization with respect to such vessels.

(b) *Receipts.* Receipts from deposited funds, in the form of interest or otherwise, may be deposited.

§ 2.1–15 Time for making deposits.

(a) *Proceeds of sale or indemnification.* Deposits of amounts representing proceeds of the sale or indemnification for loss of a vessel or share therein must be made within 60 days after receipt by the taxpayer.

(b) *Earnings and receipts.* Earnings and receipts for the taxable year may be deposited at any time. (See § 2.1–14.)

§ 2.1–16 Tax liability as to earnings deposited.

Deposit in the construction reserve fund of earnings from the operation of a vessel or vessels, or receipts, in the form of interest or otherwise, with respect to amounts previously deposited does not exempt the taxpayer from tax liability with respect thereto nor postpone the time such earnings or receipts are includible in gross income. Earnings and receipts deposited in a construction reserve fund established in accordance with the provisions of section 511 of the Act and the regulations in this part will be deemed to have been accumulated for the reasonable needs of the business within the meaning of Part 1 (section 531 and following), Subchapter G, Chapter I of the Internal Revenue Code of 1954, so long as the requirements of section 511 of the Act and the regulations in this part are satisfied relative to the use of the fund in the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels. For incurrence of tax liability due to noncompliance with the requirements of section 511 of the Act and the regulations in this part with respect to deposits in the construction reserve fund, see the provisions of § 2.1–23.

§ 2.1–17 Basis of new vessel.

The basis for determining gain or loss and for depreciation for the purpose of the Federal income tax with respect to a new vessel constructed, reconstructed, reconditioned, or acquired by the taxpayer, or with respect to which purchase-money indebtedness is liquidated as provided in section 511(g) of the Act, with funds deposited in the construction reserve fund, is reduced by the amount of the unrecognized gain represented in the funds allocated under the provisions of the regulations in this part to the cost of such vessel. (See § 2.1–18.)

§ 2.1–18 Allocation of gain for tax purposes.

(a) *General rules of allocation.* As provided in § 2.1–17, if amounts on deposit in a construction reserve fund are expended, obligated, or withdrawn for construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness of such vessels, the portion thereof which represents gain shall be applied in reduction of the basis of such new vessels. The rules set forth below in this paragraph shall apply in allocating the unrecognized gain to the amounts so expended, obligated, or withdrawn:

(1) If the ''net proceeds'' of a sale or ''net indemnity'' in respect of a loss are deposited in more than one deposit, the portion thereof representing unrecognized gain shall be considered as having been deposited first.

(2) Amounts expended, obligated, or withdrawn from the construction reserve fund shall be applied against amounts deposited in the order of deposit.

(3) If any deposit consists in part of gain not recognized under section 511(c)

of the Act, then any expenditure, obligation, or withdrawal applied against such deposit shall be considered to consist of gain in the same proportion that the part of the deposit which constitutes gain bears to the total amount of the deposit.

(b) *Date of obligation.* The date funds are obligated under a contract for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, rather than the date of payment from the fund, will determine the order of application against the deposits in the fund. When a contract for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels is entered into, amounts on deposit in the construction reserve fund will be deemed to be obligated to the extent of the amount of the taxpayer's liability under the contract. Deposits will be deemed to be so obligated in the order of deposit, each new contract obligating the earliest deposit not previously expended, obligated, or withdrawn. If the liability under the contract exceeds the amount in the construction reserve fund, the contract will be deemed to obligate, to the extent of that part of such excess not otherwise satisfied, the earliest deposit or deposits thereafter made.

(c) *Illustration.* The foregoing rules are illustrated in the following example:

Example. (1) A taxpayer who makes his returns on the calendar year basis sells a vessel in 1963 for $1,000,000, realizing a gain of $400,000. Payment of $100,000 is received in March 1963 when the contract is signed, and the balance of $900,000 is received in June 1963 on delivery of the vessel. The $1,000,000 is deposited in a construction reserve fund in July 1963. In December 1963, the taxpayer also deposits $150,000, representing earnings of that year. In 1964, he sells another vessel for $1,000,000, realizing a gain of $250,000. The sale price of $1,000,000 is received on delivery of the vessel in February 1964, and deposited in the construction reserve fund in March 1964. In September 1964, the taxpayer purchases for cash out of the construction reserve fund a new vessel for $1,750,000. To the cost of this vessel must be allocated the 1963 deposits of $1,150,000 and $600,000 of the March 1964 deposit. This leaves in the fund $400,000 of the March 1964 deposit. The amount of the unrecognized gain to be applied against the basis of the new vessel is $550,000, computed as follows: Gain of $400,000 represented in the 1963 deposits, plus the same proportion of the $250,000 gain represented in the March 1964 deposit ($1,000,000) which the amount ($600,000) allocated to the vessel is of the amount of the deposit, i.e., $400,000 plus 600,000/1,000,000 of $250,000 or $150,000, a total of $550,000. This reduces the basis of the new vessel to $1,200,000 ($1,750,000 less $550,000).

(2) In 1965, the taxpayer sells a third vessel for $3,000,000, realizing a gain of $900,000. The $3,000,000 is received and deposited in the construction reserve fund in June 1965, making a total in the fund of $3,400,000. In December 1965, the taxpayer contracts for the construction of a second new vessel to cost a maximum of $3,200,000, thereby obligating that amount of the fund, and in June 1966, receives permission to withdraw the unobligated balance amounting to $200,000. To the cost of the second new vessel must be allocated the $400,000 balance of the March 1964 deposit and $2,800,000 of the June 1965 deposit. The unrecognized gain to be applied against the basis of such new vessel is that proportion of the gain represented in each deposit which the portion of the deposit allocated to the vessel bears to the amount of such deposit, i.e., 400,000/1,000,000 of $250,000, or $100,000 plus 2,800,000/3,000,000 of $900,000, or $840,000 making a total of $940,000. The $200,000 withdrawal is applied against the June 1965 deposit and the portion thereof which represents gain will be recognized as income for 1965, the year in which realized. The computation of the recognized gain is as follows: 200,000/3,000,000 of $900,000, or $60,000.

§ 2.1–19 Requirements as to new vessels.

(a) *Requirements.* For the purposes of section 511 of the Act and the regulations in this part, the new vessel must be—

(1) Documented under the laws of the United States when it is acquired by the taxpayer, or the taxpayer must agree that when acquired it will be documented under the laws of the United States;

(2)(i) Constructed in the United States after December 31, 1939, or (ii) its construction has been financed under Title V or Title VII of the Act, or (iii) its construction has been aided by a mortgage insured under Title XI of the Act; and

(3) Either (i) of such type, size, and speed as the Administration determines to be suitable for use on the high seas or Great Lakes in carrying out the

purposes of the Act, but of not less than 2,000 gross tons or of less speed than 12 knots, except that a particular vessel may be of lesser tonnage or speed if the Administration determines and certifies that the particular vessel is desirable for use by the United States in case of war or national emergency, or (ii) constructed to replace a vessel or vessels requisitioned or purchased by the United States, in which event it must be of such type, size, and speed as to constitute a suitable replacement for the vessel requisitioned or purchased, but if a vessel already built is acquired to replace a vessel or vessels requisitioned or purchased by the United States, such vessel must meet the requirements set forth in subdivision (i) of this subparagraph. Ordinarily, under subdivision (i) of this subparagraph, a vessel constructed more than five years before the date on which deposits in a construction reserve fund are to be expended or obligated for acquisition of such vessel will not be considered suitable for use in carrying out the purpose of the Act, except that the five-year age limitation provided above in this sentence shall not apply to a vessel to be reconstructed before being placed in operation by the taxpayer.

(b) *Time of construction.* A vessel will be deemed to be constructed after December 31, 1939, only if construction was commenced after that date. Subject to the provisions of this section, a new vessel may be newly built for the taxpayer, or may be acquired after it is built.

(c) *Replacement of vessels.* It is not necessary that vessels shall be replaced vessel for vessel. The new vessels may be more or less in number than the replaced vessels, provided the other requirements of this section are met.

§ 2.1–20 Obligation of deposits.

(a) *Time for obligation.* Within three years from the date of any deposit in a construction reserve fund, unless extension is granted as provided in § 2.1–22, such deposit must be obligated under a contract for the construction or acquisition of a new vessel or vessels (or in the discretion of the Administration for a share therein), with not less than 12½ percent of the construction or contract price of the entire vessel or vessels actually paid or irrevocably committed on account thereof or must be expended or obligated for the liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company of, or a company affiliated or associated with, the mortgagor on a new vessel or vessels. Amounts on deposit in a construction reserve fund will be deemed to be obligated for expenditure when a binding contract of construction or acquisition has been entered into or when purchase-money indebtedness has been incurred and, if obligated under a contract of construction or acquisition, will be deemed to be irrevocably committed when due and payable in accordance with the terms of the contract of construction or acquisition.

(b) *Requirements for obligations.* Unless otherwise authorized by the Administration, contracts for the construction of new vessels must be for a fixed price, or provide for a base price that may be adjusted for changes in labor and material costs not exceeding 15 percent of the base price. The fixed or base price, as the case may be, shall be fair and reasonable as determined by the Maritime Administration. Any financial or other interests between the taxpayer and the contractor shall be disclosed to the Administration by the taxpayer. Plans and specifications for the new vessel or vessels must be approved by the Administration to the extent it deems necessary. A deposit in a construction reserve fund may be expended or obligated for expenditure for procurement under an acquisition or construction contract of a part interest in a new vessel or vessels only after obtaining the written consent of the Administration. The granting of such consent shall be entirely in the discretion of the Administration and it may impose such conditions with respect thereto as it may deem necessary or advisable for the purpose of carrying out the provisions of section 511 of the Act. Applications for such consent shall be executed in triplicate, and, together with eight conformed copies thereof, filed with the Administration.

§2.1–21 Period for construction of certain vessels.

A new vessel constructed otherwise than under the provisions of Title V of the Act, and not purchased from the Administration must, within six months from the date of the construction contract, or within the period of any extension, be completed to the extent of not less than 5 percent as estimated by the Administration and certified by it to the Secretary of the Treasury. In case of a contract covering more than one vessel it will be sufficient if one of the vessels is 5 percent completed within the six months' period from the date of the contract or within the period of any extension, and so certified. All construction must be completed with reasonable dispatch as determined by the Administration. If, for causes within the control of the taxpayer, the entire construction is not completed with reasonable dispatch, the Administration will so certify to the Secretary of the Treasury. For the effect of such certification, see §2.1–23.

§2.1–22 Time extensions for expenditure or obligation.

(a) *Extensions.* The Administration, upon application and a showing of proper circumstances, (1) may allow an extension of time within which deposits shall be expended or obligated, not to exceed one year, and upon a second application received before the expiration of the first extension, may allow an additional extension not to exceed one year, and (2) may allow an extension or extensions of time within which five percent of the construction shall have been completed as provided in §2.1–21 not to exceed one year in the aggregate, and (3) may allow any other extensions that may be provided by amendment to the Act.

(b) *Application required.* A taxpayer seeking an extension of time shall make application therefor, and transmit it with an appropriate statement of the circumstances, including the reasons justifying the requested extension or extensions, and appropriate documents in substantiation of the statement, to the Administration. The Administration will notify the Commissioner of Internal Revenue of any extension granted. In case an application for extension is denied, the taxpayer will be liable for delay as though no application had been made.

§2.1–23 Noncompliance with requirements.

(a) *Noncompliance.* The amount of the gain which is that portion of the construction reserve fund otherwise constituting taxable income under the law applicable to the taxable year in which such gain was realized shall be included in the taxpayer's gross income for such taxable year for income or excess-profits tax purposes, if—

(1) A portion of such fund is withdrawn for purposes other than—

(i) The construction, reconstruction, reconditioning, or acquisition of a new vessel; or

(ii) The liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company of, or a company affiliated or associated with, the mortgagor on a new vessel or vessels; or

(2) The taxpayer fails to comply with the requirements of section 511 of the Act or the regulations in this part relating to the utilization of construction reserve funds in the construction, reconstruction, reconditioning, or acquisition of a new vessel, or the liquidation of purchase-money indebtedness on such a vessel.

If securities on deposit in a construction reserve fund are sold and the amount placed in the fund in lieu thereof is less than the value of the securities at the time of their deposit, the difference between such value and the amount placed in the fund in lieu of the securities will be deemed to have been withdrawn. With respect to the substitution of new financing in the case of an irrevocable commitment, see paragraph (d) of §2.1–13.

(b) *Amount recognized.* In the event of noncompliance with the prescribed conditions relative to any contract for construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, recognition will extend to the entire amount of the gain represented in that portion of the construction reserve fund obligated under such contract.

Thus, if the Administration determines and certifies to the Secretary of the Treasury that for causes within the control of the taxpayer construction under a contract is not completed with reasonable dispatch, the entire amount of the gain represented in the portion of the construction reserve fund obligated under the contract will be recognized even though all other conditions have been satisfied. In case of noncompliance with the requirements of section 511 of the Act or the regulations in this part, see the provisions of § 2.1–18 as to the allocation of gain.

(c) *Unreasonable accumulation.* Noncompliance with the provisions of section 511 of the Act or the regulations in this part relative to the utilization of the deposited amounts may also, inasmuch as the provision of section 511(f) of the Act is then inapplicable, warrant an examination to ascertain whether such amounts constitute an unreasonable accumulation of earnings and profits within the meaning of Part I (section 531 and following), Subchapter G, Chapter I of the Internal Revenue Code of 1954, or corresponding provisions of prior law. If amounts are deposited and the fund maintained in good faith for the purpose of construction, reconstruction, reconditioning, and acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, such amounts will be deemed to have been accumulated for the reasonable needs of the business.

§ 2.1–24 Extent of tax liability.

(a) *Declared value excess-profits tax.* Gain which is includible in gross income under § 2.1–23 shall be included in gross income for all income and excess-profits tax purposes, but not for the purposes of the declared value excess-profits tax and the capital stock tax as provided in section 511(i) of the Act. In lieu of any adjustment with respect to such declared value excess-profits tax, there is imposed for any taxable year ending on or before June 30, 1945, in which the gain is realized an additional tax of 1.1 percent of the amount of the gain. No additional capital stock tax liability is incurred.

(b) *Improper deposits.* In the case of deposits in the construction reserve fund of amounts derived from sources other than those specified in section 511 of the Act, or in the case of failure to deposit an amount equal to the ''net proceeds'' or ''net indemnity'' within the period prescribed in section 511(c) of the Act and § 2.1–15, the taxpayer obtains no suspension or postponement of any tax liability and the tax is collectible without regard to the provisions of section 511(c) of the Act.

(c) *Time for filing claim subsequent to election under section 511(c)(2).* If an election is made under section 511(c)(2) of the Act and paragraph (a)(2) of § 2.1–12, and if computation or recomputation in accordance therewith is otherwise allowable but is prevented, on the date of filing of notice of such election, or within six months thereafter, by any statute of limitation; such computation or recomputation nevertheless shall be made notwithstanding such statute if a claim therefor is filed within six months after the date of making such election. If as the result of such computation or recomputation an overpayment is disclosed a claim for refund should be made in accordance with § 301.6402–3 within such six months' period. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see § 301.6402–2 of this chapter (Regulations on Procedure and Administration), relating to claims for credit or refund.

[T.D. 6820, 30 FR 6030, Apr. 29, 1965, as amended by T.D. 7410, 41 FR 11020, Mar. 16, 1976]

§ 2.1–25 Assessment and collection of deficiencies.

Any additional tax, including the 1.1 percent amount imposed by section 511(i) of the Act, due on account of withdrawal from a construction reserve fund, or failure to comply with section 511 of the Act or the regulations in this part, is collectible as a deficiency. Interest upon such deficiency will run from the date the withdrawal or noncompliance occurs. The amount of any deficiency, including interest and additions to the tax, determined as a result of such withdrawal or noncompliance, may be assessed, or a proceeding in court for the collection thereof may be begun without assessment, at any time and without regard to any period of limitations or any other provisions of

law or rule of law, including the doctrine of res judicata.

§2.1–26 Reports by taxpayers.

(a) *Information required.* With each income tax return filed for a taxable year during any part of which a construction reserve fund is in existence the taxpayer shall submit a statement setting forth a detailed analysis of such fund. The statement, which need not be on any prescribed form, shall include the following information with respect to the construction reserve fund:

(1) The actual balance in the fund at the beginning and end of the taxable year;

(2) The date, amount, and source of each deposit during the taxable year;

(3) If any deposit referred to in subparagraph (2) of this paragraph consists of proceeds from the sale, or indemnification of loss, of a vessel or share thereof, the amounts of the unrecognized gain;

(4) The date, amount, and purpose of each expenditure or withdrawal from the fund; and

(5) The date and amount of each contract, under which deposited funds are deemed to be obligated during the taxable year, for the construction, reconstruction, reconditioning, or acquisition of new vessels, or for the liquidation of purchase-money indebtedness on such vessels, and the identification of such vessels.

(b) *Records required.* Taxpayers shall keep such records and make such additional reports as the Commissioner of Internal Revenue or the Administration may require.

§2.1–27 Controlled corporation.

For the purpose of section 511 of the Act and the regulations in this part a new vessel is considered as constructed, reconstructed, reconditioned, or acquired by the taxpayer if constructed, reconstructed, reconditioned, or acquired by a corporation at a time when the taxpayer owns not less than 95 percent of the total number of shares of each class of stock of the corporation.

§2.1–28 Administrative jurisdiction.

Sections 2.1–3 to 2.1–11, inclusive, §§2.1–13 to 2.1–15, inclusive, and §§2.1–19 to 2.1–22, inclusive, deal primarily with matters under the jurisdiction of the Administration. Sections 2.1–12, 2.1–16 to 2.1–18, inclusive, and §§2.1–23 to 2.1–27, inclusive, deal primarily with matters under the jurisdiction of the Commissioner of Internal Revenue. Generally, matters relating to the establishment, maintenance, expenditure, and use of construction reserve funds and the construction, reconstruction, reconditioning, or acquisition of new vessels are under the jurisdiction of the Administration; and matters relating to the determination, assessment, and collection of taxes are under the jurisdiction of the Commissioner of Internal Revenue. Correspondence should be addressed to the particular authority having jurisdiction in the matter.

PART 3—CAPITAL CONSTRUCTION FUND

Sec.

3.0 Statutory provisions; section 607, Merchant Marine Act, 1936, as amended.
3.1 Scope of section 607 of the Act and the regulations in this part.
3.2 Ceiling on deposits.
3.3 Nontaxability of deposits.
3.4 Establishment of accounts.
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3.7 Tax treatment of nonqualified withdrawals.
3.8 Certain corporate reorganizations and changes in partnerships, and certain transfers on death. [Reserved]
3.9 Consolidated returns. [Reserved]
3.10 Transitional rules for existing funds.
3.11 Definitions.

AUTHORITY: Sec. 21(a) of the Merchant Marine Act of 1970 (84 Stat. 1026); sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

SOURCE: T.D. 7398, 41 FR 5812, Feb. 10, 1976, unless otherwise noted.

§3.0 Statutory provisions; section 607, Merchant Marine Act, 1936, as amended.

SEC. 607 (a) Agreement Rules.

Any citizen of the United States owning or leasing one or more eligible vessels (as defined in subsection (k)(1)) may enter into an agreement with the Secretary of Commerce under, and as provided in, this section to establish a capital construction fund (hereinafter in this section referred to as the ''fund'') with respect to any or all of such vessels. Any agreement entered into under

this section shall be for the purpose of providing replacement vessels, additional vessels, or reconstructed vessels, built in the United States and documented under the laws of the United States for operation in the United States, foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States and shall provide for the deposit in the fund of the amounts agreed upon as necessary or appropriate to provide for qualified withdrawals under subsection (f). The deposits in the fund, and all withdrawals from the fund, whether qualified or nonqualified, shall be subject to such conditions and requirements as the Secretary of Commerce may by regulations prescribe or are set forth in such agreement; except that the Secretary of Commerce may not require any person to deposit in the fund for any taxable year more than 50 percent of that portion of such person's taxable income for such year (computed in the manner provided in subsection (b)(1)(A)) which is attributable to the operation of the agreement vessels.

(b) Ceiling on Deposits.

(1) The amount deposited under subsection (a) in the fund for any taxable year shall not exceed the sum of:

(A) That portion of the taxable income of the owner or lessee for such year (computed as provided in chapter 1 of the Internal Revenue Code of 1954 but without regard to the carryback of any net operating loss or net capital loss and without regard to this section) which is attributable to the operation of the agreement vessels in the foreign or domestic commerce of the United States or in the fisheries of the United States,

(B) The amount allowable as a deduction under section 167 of the Internal Revenue Code of 1954 for such year with respect to the agreement vessels,

(C) If the transaction is not taken into account for purposes of subparagraph (A), the net proceeds (as defined in joint regulations) from (i) the sale or other disposition of any agreement vessel, or (ii) insurance or indemnity attributable to any agreement vessel, and

(D) The receipts from the investment or reinvestment of amounts held in such fund.

(2) In the case of a lessee, the maximum amount which may be deposited with respect to an agreement vessel by reason of paragraph (1)(B) for any period shall be reduced by any amount which, under an agreement entered into under this section, the owner is required or permitted to deposit for such period with respect to such vessel by reason of paragraph (1)(B).

(3) For purposes of paragraph (1), the term ''agreement vessel'' includes barges and containers which are part of the complement of such vessel and which are provided for in the agreement.

(c) Requirements as to Investments.

Amounts in any fund established under this section shall be kept in the depository or depositories specified in the agreement and shall be subject to such trustee and other fiduciary requirements as may be specified by the Secretary of Commerce. They may be invested only in interest-bearing securities approved by the Secretary of Commerce; except that, if the Secretary of Commerce consents thereto, an agreed percentage (not in excess of 60 percent) of the assets of the fund may be invested in the stock of domestic corporations. Such stock must be currently fully listed and registered on an exchange registered with the Securities and Exchange Commission as a national securities exchange, and must be stock which would be acquired by prudent men of discretion and intelligence in such matters who are seeking a reasonable income and the preservation of their capital. If at any time the fair market value of the stock in the fund is more than the agreed percentage of the assets in the fund, any subsequent investment of amounts deposited in the fund, and any subsequent withdrawal from the fund, shall be made in such a way as to tend to restore the fund to a situation in which the fair market value of the stock does not exceed such agreed percentage. For purposes of this subsection, if the common stock of a corporation meets the requirements of this subsection and if the preferred stock of such corporation would meet such requirements but for the fact that it cannot be listed and registered as required because it is nonvoting stock, such preferred stock shall be treated as meeting the requirements of this subsection.

(d) Nontaxability for Deposits.

(1) For purposes of the Internal Revenue Code of 1954—

(A) Taxable income (determined without regard to this section) for the taxable year shall be reduced by an amount equal to the amount deposited for the taxable year out of amounts referred to in subsection (b)(1)(A),

(B) Gain from a transaction referred to in subsection (b)(1)(C) shall not be taken into account if an amount equal to the net proceeds (as defined in joint regulations) from such transaction is deposited in the fund,

(C) The earnings (including gains and losses) from the investment and reinvestment of amounts held in the fund shall not be taken into account,

(D) The earnings and profits of any corporation (within the meaning of section 316 of such Code) shall be determined without regard to this section, and

(E) In applying the tax imposed by section 531 of such Code (relating to the accumulated earnings tax), amounts while held in the fund shall not be taken into account.

(2) Paragraph (1) shall apply with respect to any amount only if such amount is deposited in the fund pursuant to the agreement

and not later than the time provided in joint regulations.

(e) Establishment of Accounts.

For purposes of this section—

(1) Within the fund established pursuant to this section three accounts shall be maintained:

(A) The capital account,

(B) The capital gain account, and

(C) The ordinary income account.

(2) The capital account shall consist of—

(A) Amounts referred to in subsection (b)(1)(B),

(B) Amounts referred to in subsection (b)(1)(C) other than that portion thereof which represents gain not taken into account by reason of subsection (d)(1)(B),

(C) 85 percent of any dividend received by the fund with respect to which the person maintaining the fund would (but for subsection (d)(1)(C)) be allowed a deduction under section 243 of the Internal Revenue Code of 1954, and

(D) Interest income exempt from taxation under section 103 of such Code.

(3) The capital gain account shall consist of—

(A) Amounts representing capital gains on assets held for more than 6 months and referred to in subsection (b)(1)(C) or (b)(1)(D), reduced by—

(B) Amounts representing capital losses on assets held in the fund for more than 6 months.

(4) The ordinary income account shall consist of—

(A) Amounts referred to in subsection (b)(1)(A),

(B)(i) Amounts representing capital gains on assets held for 6 months or less and referred to in subsection (b)(1)(C) or (b)(1)(D), reduced by—

(ii) Amounts representing capital losses on assets held in the fund for 6 months or less,

(C) Interest (not including any tax-exempt interest referred to in paragraph (2)(D)) and other ordinary income (not including any dividend referred to in subparagraph (E)) received on assets held in the fund,

(D) Ordinary income from a transaction described in subsection (b)(1)(C), and

(E) 15 percent of any dividend referred to in paragraph (2)(C).

(5) Except on termination of a fund, capital losses referred to in paragraph (3)(B) or in paragraph (4)(B)(ii) shall be allowed only as an offset to gains referred to in paragraph (3)(A) or (4)(B)(i), respectively.

(f) Purposes of Qualified Withdrawals.

(1) A qualified withdrawal from the fund is one made in accordance with the terms of the agreement but only if it is for:

(A) The acquisition, construction, or reconstruction of a qualified vessel,

(B) The acquisition, construction, or reconstruction of barges and containers which are part of the complement of a qualified vessel, or

(C) The payment of the principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of a qualified vessel or a barge or container which is part of the complement of a qualified vessel.

Except to the extent provided in regulations prescribed by the Secretary of Commerce, subparagraph (B), and so much of subparagraph (C) as relates only to barges and containers, shall apply only with respect to barges and containers constructed in the United States.

(2) Under joint regulations, if the Secretary of Commerce determines that any substantial obligation under any agreement is not being fulfilled, he may, after notice and opportunity for hearing to the person maintaining the fund, treat the entire fund or any portion thereof as an amount withdrawn from the fund in a nonqualified withdrawal.

(g) Tax Treatment of Qualified Withdrawals.

(1) Any qualified withdrawal from a fund shall be treated—

(A) First as made out of the capital account,

(B) Second as made out of the capital gain account, and

(C) Third as made out of the ordinary income account.

(2) If any portion of a qualified withdrawal for a vessel, barge, or container is made out of the ordinary income account, the basis of such vessel, barge, or container shall be reduced by an amount equal to such portion.

(3) If any portion of a qualified withdrawal for a vessel, barge, or container is made out of the capital gain account, the basis of such vessel, barge, or container shall be reduced by an amount equal to—

(A) Five-eighths of such portion, in the case of a corporation (other than an electing small business corporation, as defined in section 1371 of the Internal Revenue Code of 1954), or

(B) One-half of such portion, in the case of any other person.

(4) If any portion of a qualified withdrawal to pay the principal on any indebtedness is made out of the ordinary income account or the capital gain account, then an amount equal to the aggregate reduction which would be required by paragraphs (2) and (3) if this were a qualified withdrawal for a purpose described in such paragraphs shall be applied, in the order provided in joint regulations, to reduce the basis of vessels, barges, and containers owned by the person maintaining the fund. Any amount of a withdrawal remaining after the application of the preceding sentence shall be treated as a nonqualified withdrawal.

(5) If any property the basis of which was reduced under paragraph (2), (3), or (4) is disposed of, any gain realized on such disposition, to the extent it does not exceed the aggregate reduction in the basis of such property under such paragraphs, shall be treated as an amount referred to in subsection (h)(3)(A) which was withdrawn on the date of such disposition. Subject to such conditions and requirements as may be provided in joint regulations, the preceding sentence shall not apply to a disposition where there is a redeposit in an amount determined under joint regulations which will, insofar as practicable, restore the fund to the position it was in before the withdrawal.

(h) Tax Treatment of Nonqualified Withdrawals.

(1) Except as provided in subsection (i), any withdrawal from a fund which is not a qualified withdrawal shall be treated as a nonqualified withdrawal.

(2) Any nonqualified withdrawal from a fund shall be treated—

(A) First as made out of the ordinary income account,

(B) Second as made out of the capital gain account, and

(C) Third as made out of the capital account.

For purposes of this section, items withdrawn from any account shall be treated as withdrawn on a first-in-first-out basis; except that (i) any nonqualified withdrawal for research, development, and design expenses incident to new and advanced ship design, machinery and equipment, and (ii) any amount treated as a nonqualified withdrawal under the second sentence of subsection (g)(4), shall be treated as withdrawn on a last-in-first-out basis.

(3) For purposes of the Internal Revenue Code of 1954—

(A) Any amount referred to in paragraph (2)(A) shall be included in income as an item of ordinary income for the taxable year in which the withdrawal is made.

(B) Any amount referred to in paragraph (2)(B) shall be included in income for the taxable year in which the withdrawal is made as an item of gain realized during such year from the disposition of an asset held for more than 6 months, and

(C) For the period on or before the last date prescribed for payment of tax for the taxable year in which this withdrawal is made—

(i) No interest shall be payable under section 6601 of such Code and no addition to the tax shall be payable under section 6651 of such Code,

(ii) Interest on the amount of the additional tax attributable to any item referred to in subparagraph (A) or (B) shall be paid at the applicable rate (as defined in paragraph (4)) from the last date prescribed for payment of the tax for the taxable year for which such item was deposited in the fund, and

(iii) No interest shall be payable on amounts referred to in clauses (i) and (ii) of paragraph (2) or in the case of any nonqualified withdrawal arising from the application of the recapture provision of section 606(5) of the Merchant Marine Act of 1936 as in effect on December 31, 1969.

(4) For purposes of paragraph (3)(C)(ii), the applicable rate of interest for any nonqualified withdrawal—

(A) Made in a taxable year beginning in 1970 or 1971 is 8 percent, or

(B) Made in a taxable year beginning after 1971, shall be determined and published jointly by the Secretary of the Treasury and the Secretary of Commerce and shall bear a relationship to 8 percent which the Secretaries determine under joint regulations to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields for the calendar year 1970.

(i) Certain Corporate Reorganizations and Changes in Partnerships.

Under joint regulations—

(1) A transfer of a fund from one person to another person in a transaction to which section 381 of the Internal Revenue Code of 1954 applies may be treated as if such transaction did not constitute a nonqualified withdrawal, and

(2) A similar rule shall be applied in the case of a continuation of a partnership (within the meaning of subchapter K of such Code).

(j) Treatment of Existing Funds.

(1) Any person who was maintaining a fund or funds (hereinafter in this subsection referred to as ''old fund'') under this section (as in effect before the enactment of this subsection) may elect to continue such old fund but—

(A) May not hold moneys in the old fund beyond the expiration date provided in the agreement under which such old fund is maintained (determined without regard to any extension or renewal entered into after April 14, 1970),

(B) May not simultaneously maintain such old fund and a new fund established under this section, and

(C) If he enters into an agreement under this section to establish a new fund, may agree to the extension of such agreement to some or all of the amounts in the old fund.

(2) In the case of any extension of an agreement pursuant to paragraph (1)(C), each item in the old fund to be transferred shall be transferred in a nontaxable transaction to the appropriate account in the new fund established under this section. For purposes of subsection (h)(3)(C), the date of the deposit of any item so transferred shall be July 1,

1971, or the date of the deposit in the old fund, whichever is the later.

(k) Definitions.

For purposes of this section—

(1) The term ''eligible vessel'' means any vessel—

(A) Constructed in the United States and, if reconstructed, reconstructed in the United States,

(B) Documented under the laws of the United States, and

(C) Operated in the foreign or domestic commerce of the United States or in the fisheries of the United States.

Any vessel which (i) was constructed outside of the United States but documented under the laws of the United States on April 15, 1970, or (ii) constructed outside the United States for use in the United States foreign trade pursuant to a contract entered into before April 15, 1970, shall be treated as satisfying the requirements of subparagraph (A) of this paragraph and the requirements of subparagraph (A) of paragraph (2).

(2) The term ''qualified vessel'' means any vessel—

(A) Constructed in the United States and, if reconstructed, reconstructed in the United States,

(B) Documented under the laws of the United States, and

(C) Which the person maintaining the fund agrees with the Secretary of Commerce will be operated in the United States foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States.

(3) The term ''agreement vessel'' means any eligible vessel or qualified vessel which is subject to an agreement entered into under this section.

(4) The term ''United States,'' when used in a geographical sense, means the continental United States including Alaska, Hawaii, and Puerto Rico.

(5) The term ''United States foreign trade'' includes (but is not limited to) those areas in domestic trade in which a vessel built with construction-differential subsidy is permitted to operate under the first sentence of section 506 of this Act.

(6) The term ''joint regulations'' means regulations prescribed under subsection (1).

(7) The term ''vessel'' includes cargo handling equipment which the Secretary of Commerce determines is intended for use primarily on the vessel. The term ''vessel'' also includes an ocean-going towing vessel or an ocean-going barge or comparable towing vessel or barge operated on the Great Lakes.

(8) The term ''noncontiguous trade'' means (i) trade between the contiguous forty-eight States on the one hand and Alaska, Hawaii, Puerto Rico, and the insular territories and possessions of the United States on the other hand, and (ii) trade from any point in Alaska, Hawaii, Puerto Rico, and such territories and possessions to any other point in Alaska, Hawaii, Puerto Rico, and such territories and possessions.

(l) Records; Reports; Changes in Regulations.

Each person maintaining a fund under this section shall keep such records and shall make such reports as the Secretary of Commerce or the Secretary of the Treasury shall require. The Secretary of the Treasury and the Secretary of Commerce shall jointly prescribe all rules and regulations, not inconsistent with the foregoing provisions of this section, as may be necessary or appropriate to the determination of tax liability under this section. If, after an agreement has been entered into under this section, a change is made either in the joint regulations or in the regulations prescribed by the Secretary of Commerce under this section which could have a substantial effect on the rights or obligations of any person maintaining a fund under this section, such person may terminate such agreement.

§3.1 Scope of section 607 of the Act and the regulations in this part.

(a) *In general.* The regulations prescribed in this part provide rules for determining the income tax liability of any person a party to an agreement with the Secretary of Commerce establishing a capital construction fund (for purposes of this part referred to as the ''fund'') authorized by section 607 of the Merchant Marine Act, 1936, as amended (for purposes of this part referred to as the ''Act''). With respect to such parties, section 607 of the Act in general provides for the nontaxability of certain deposits of money or other property into the fund out of earnings or gains realized from the operation of vessels covered in an agreement, gains realized from the sale or other disposition of agreement vessels or proceeds from insurance for indemnification for loss of agreement vessels, earnings from the investment or reinvestment of amounts held in a fund, and gains with respect to amounts or deposits in the fund. Transitional rules are also provided for the treatment of ''old funds'' existing on or before the effective date of the Merchant Marine Act of 1970 (see §3.10).

(b) *Cross references.* For rules relating to eligibility for a fund, deposits, and withdrawals and other aspects, see the regulations prescribed by the Secretary

of Commerce in titles 46 (Merchant Marine) and 50 (Fisheries) of the *Code of Federal Regulations.*

(c) *Code.* For purposes of this part, the term ''Code'' means the Internal Revenue Code of 1954, as amended.

§ 3.2 Ceiling on deposits.

(a) *In general*—(1) *Total ceiling.* Section 607(b) of the Act provides a ceiling on the amount which may be deposited by a party for a taxable year pursuant to an agreement. The amount which a party may deposit into a fund may not exceed the sum of the following subceilings:

(i) The lower of *(a)* the taxable income (if any) of the party for such year (computed as provided in Chapter I of the Code but without regard to the carryback of any net operating loss or net capital loss and without regard to section 607 of the Act) or *(b)* taxable income (if any) of such party for such year attributable under paragraph (b) of this section to the operation of agreement vessels (as defined in paragraph (f) of this section) in the foreign or domestic commerce of the United States or in the fisheries of the United States (see section 607(b)(1)(A) of the Act).

(ii) Amounts allowable as a deduction under section 167 of the Code for such year with respect to the agreement vessels (see section 607(b)(1)(B) of the Act),

(iii) The net proceeds (if not included in subdivision (i) of this paragraph) from *(a)* the sale or other disposition of any agreement vessels or *(b)* insurance or indemnity attributable to any agreement vessels (see section 607(b)(1)(C) of the Act and paragraph (c) of this section), and

(iv) Earnings and gains from the investment or reinvestment of amounts held in such fund (see section 607(b)(1)(D) of the Act and paragraphs (d) and (g) of this section).

(2) *Overdeposits.* (i) If for any taxable year an amount is deposited into the fund under a subceiling computed under subparagraph (1) of this paragraph which is in excess of the amount of such subceiling for such year, then at the party's option such excess (or any portion thereof) may—

(a) Be treated as a deposit into the fund for that taxable year under another available subceiling, or

(b) Be treated as not having been deposited for the taxable year and thus, at the party's option, may be disposed of either by it being—

(1) Treated as a deposit into the fund under any subceiling available in the first subsequent taxable year in which a subceiling is available, in which case such amount shall be deemed to have been deposited on the first day of such subsequent taxable year, or

(2) Repaid to the party from the fund.

(ii)*(a)* When a correction is made for an overdeposit, proper adjustment shall be made with respect to all items for all taxable years affected by the overdeposit, such as, for example, amounts in each account described in § 3.4, treatment of nonqualified withdrawals, the consequences of qualified withdrawals and the treatment of losses realized or treated as realized by the fund. Thus, for example, if the party chooses to have the fund repay to him the amount of an overdeposit, amounts in each account, basis of assets, and any affected item will be determined as though no deposit and repayment had been made. Accordingly, in such a case, if there are insufficient amounts in an account to cover a repayment of an overdeposit (as determined before correcting the overdeposit), and the party had applied the proceeds of a qualified withdrawal from such account towards the purchase of a qualified vessel (within the meaning of § 3.11(a)(2)), then such account and the basis of the vessel shall be adjusted as of the time such withdrawal was made and proceeds were applied, and repayment shall be made from such account as adjusted. If a party chooses to treat the amount of an overdeposit as a deposit under a subceiling for a subsequent year, similar adjustments to affected items shall be made. If the amount of a withdrawal would have exceeded the amount in the fund (determined after adjusting all affected amounts by reason of correcting the overdeposit), the withdrawal to the extent of such excess shall be treated as a repayment made at the time the withdrawal was made.

(b) If the accounts (as defined in § 3.4) that were increased by reason of excessive deposits contain sufficient amounts at the time the overdeposit is discovered to repay the party, the party may, at his option, demand repayment of such excessive deposits from such accounts in lieu of making the adjustments required by *(a)* of this subdivision (ii).

(iii) During the period beginning with the day after the date an overdeposit was actually made and ending with the date it was disposed of in accordance with subdivision (i)*(b)* of this subparagraph, there shall be included in the party's gross income for each taxable year the earnings attributed to any amount of overdeposit on hand during such a year. The earnings attributable to any amount of overdeposit on hand during a taxable year shall be an amount equal to the product of—

(a) The average daily earnings for each one dollar in the fund (as determined in subdivision (iv) of this subparagraph),

(b) The amount of overdeposit (as determined in subdivision (vi) of this subparagraph), and

(c) The number of days during the taxable year the overdeposit existed.

(iv) For purposes of subdivision (iii) *(a)* of this subparagraph, the average daily earnings for each dollar in the fund shall be determined by dividing the total earnings of the fund for the taxable year by the sum of the products of—

(a) Any amount on hand during the taxable year (determined under subdivision (v) of this subparagraph), and

(b) The number of days during the taxable year such amount was on hand in the fund.

(v) For purposes of this subparagraph—

(a) An amount on hand in the fund or an overdeposit shall not be treated as on hand on the day deposited but shall be treated as on hand on the day withdrawn, and

(b) The fair market value of such amounts on hand for purposes of this subparagraph shall be determined as provided in § 20.2031–2 of the Estate Tax Regulations of this chapter but without applying the blockage and other special rules contained in paragraph (e) thereof.

(vi) For purposes of subdivision (iii) *(b)* of this subparagraph, the amount of overdeposit on hand at any time is an amount equal to—

(a) The amount deposited into the fund under a subceiling computed under subparagraph (1) of this paragraph which is in excess of the amount of such subceiling, less

(b) The sum of—

(1) Amounts described in *(a)* of this subdivision (vi) treated as a deposit under another subceiling for the taxable year pursuant to subdivision (i) of this subparagraph,

(2) Amounts described in *(a)* of this subdivision (vi) disposed of (or treated as disposed of) in accordance with subdivision (i) or (ii) of this subparagraph prior to such time.

(vii) To the extent earnings attributed under subdivision (iii) of this subparagraph represent a deposit for any taxable year in excess of the subceiling described in subparagraph (1)(iv) of this paragraph for receipts from the investment or reinvestment of amounts held in the fund, such attributed earnings shall be subject to the rules of this subparagraph for overdeposits.

(3) *Underdeposit caused by audit adjustment.* [Reserved]

(4) *Requirements for deficiency deposits.* [Reserved]

(b) *Taxable income attributable to the operation of an agreement vessel*—(1) *In general.* For purposes of this section, taxable income attributable to the operation of an agreement vessel means the amount, if any, by which the gross income of a party for the taxable year from the operation of an agreement vessel (as defined in paragraph (f) of this section) exceeds the allowable deductions allocable to such operation (as determined under subparagraph (3) of this paragraph). The term ''taxable income attributable to the operation of the agreement vessels'' means the sum of the amounts described in the preceding sentence separately computed with respect to each agreement vessel (or share therein) or, at the party's option, computed in the aggregate.

(2) *Gross income.* (i) Gross income from the operation of agreement vessels means the sum of the revenues

which are derived during the taxable year from the following:

(a) Revenues derived from the transportation of passengers, freight, or mail in such vessels, including amounts from contracts for the charter of such vessels to others, from operating differential subsidies, from collections in accordance with pooling agreements and from insurance or indemnity net proceeds relating to the loss of income attributable to such agreement vessels.

(b) Revenues derived from the operation of agreement vessels relating to commercial fishing activities, including the transportation of fish, support activities for fishing vessels, charters for commercial fishing, and insurance or indemnity net proceeds relating to the loss of income attributable to such agreement vessels.

(c) Revenues from the rental, lease, or use by others of terminal facilities, revenues from cargo handling operations and tug and lighter operations, and revenues from other services or operations which are incidental and directly related to the operation of an agreement vessel. Thus, for example, agency fees, commissions, and brokerage fees derived by the party at his place of business for effecting transactions for services incidental and directly related to shipping for the accounts of other persons are includible in gross income from the operation of agreement vessels where the transaction is of a kind customarily consummated by the party for his own account at such place of business.

(d) Dividends, interest, and gains derived from assets set aside and reasonably retained to meet regularly occurring obligations relating to the shipping or fishing business directly connected with the agreement vessel which obligations cannot at all times be met from the current revenues of the business because of layups or repairs, special surveys, fluctuations in the business, and reasonably foreseeable strikes (whether or not a strike actually occurs), and security amounts retained by reason of participation in conferences, pooling agreements, or similar agreements.

(ii) The items of gross income described in subdivision (i) *(c)* and *(d)* of this subparagraph shall be considered to be derived from the operations of a particular agreement vessel in the same proportion that the sum of the items of gross income described in subdivision (i) *(a)* and *(b)* of this subparagraph which are derived from the operations of such agreement vessel bears to the party's total gross income for the taxable year from operations described in subdivision (i) *(a)* and *(b)* of this subparagraph.

(iii) In the case of a party who uses his own or leased agreement vessels to transport his own products, the gross income attributable to such vessel operations is an amount determined to be an arm's length charge for such transportation. The arm's length charge shall be determined by applying the principles of section 482 of the Code and the regulations thereunder as if the party transporting the product and the owner of the product were not the same person but were controlled taxpayers within the meaning of § 1.482–1(a)(4) of the Income Tax Regulations of this chapter. Gross income attributable to the operation of agreement vessels does not include amounts for which the party is allowed a deduction for percentage depletion under sections 611 and 613 of the Code.

(3) *Deductions.* From the gross income attributable to the operation of an agreement vessel or vessels as determined under subparagraph (2) of this paragraph, there shall be deducted, in accordance with the principles of § 1.861–8 of the Income Tax Regulations of this chapter, the expenses, losses, and other deductions definitely related and therefore allocated and apportioned thereto and a ratable part of any expenses, losses, or other deductions which are not definitely related to any gross income of the party. Thus, for example, if a party has gross income attributable to the operation of an agreement vessel and other gross income and has a particular deduction definitely related to both types of gross income, such deduction must be apportioned between the two types of gross income on a reasonable basis in determining the taxable income attributable to the operation of the agreement vessel.

(4) *Net operating and capital loss deductions.* The taxable income of a party attributable to the operation of agreement vessels shall be computed without regard to the carryback of any net operating loss deduction allowed by section 172 of the Code, the carryback of any net capital loss deduction allowed by sections 165(f) of the Code, or any reduction in taxable income allowed by section 607 of the Act.

(5) *Method of accounting.* Taxable income must be computed under the method of accounting which the party uses for Federal income tax purposes. Such method may include a method of reporting whereby items of revenue and expense properly allocable to voyages in progress at the end of any accounting period are eliminated from the computation of taxable income for such accounting period and taken into account in the accounting period in which the voyage is completed.

(c) *Net proceeds from transactions with respect to agreement vessels.* [Reserved]

(d) *Earnings and gains from the investment or reinvestment of amounts held in a fund*—(1) *In general.* (i) Earnings and gains received or accrued by a party from the investment or reinvestment of assets in a fund is the total amount of any interest or dividends received or accrued, and gains realized, by the party with respect to assets deposited in, or purchased with amounts deposited in, such fund. Such earnings and gains are therefore required to be included in the gross income of the party unless such amount, or a portion thereof, is not taken into account under section 607(d)(1)(C) of the Act and § 3.3(b)(2)(ii) by reason of a deposit or deemed deposit into the fund. For rules relating to receipts from the sale or other disposition of nonmoney deposits into the fund, see paragraph (g) of this section.

(ii) Earnings received or accrued by a party from investment or reinvestment of assets in a fund include the ratable monthly portion of original issue discount included in gross income pursuant to section 1232(a)(3) of the Code. Such ratable monthly portion shall be deemed to be deposited into the ordinary income account of the fund, but an actual deposit representing such ratable monthly portion shall not be made. For basis of a bond or other evidence of indebtedness issued at a discount, see § 3.3(b)(2)(ii)*(b)*.

(2) *Gain realized.* (i) The gain realized with respect to assets in the fund is the excess of the amount realized (as defined in section 1001(b) of the Code and the regulations thereunder) by the fund on the sale or other disposition of a fund asset over its adjusted basis (as defined in section 1011 of the Code) to the fund. For the adjusted basis of nonmoney deposits, see paragraph (g) of this section.

(ii) Property purchased by the fund (including property considered under paragraph (g)(1)(iii) of this section as purchased by the fund) which is withdrawn from the fund in a qualified withdrawal (as defined in § 3.5) is treated as a disposition to which subdivision (i) of this subparagraph applies. For purposes of determining the amount by which the balance within a particular account will be reduced in the manner provided in § 3.6(b) (relating to order of application of qualified withdrawals against accounts) and for purposes of determining the reduction in basis of a vessel, barge, or container (or share therein) pursuant to § 3.6(c), the value of the property is its fair market value on the day of the qualified withdrawal.

(3) *Holding period.* Except as provided in paragraph (g) of this section, the holding period of fund assets shall be determined under section 1223 of the Code.

(e) *Leased vessels.* In the case of a party who is a lessee of an agreement vessel, the maximum amount which such lessee may deposit with respect to any agreement vessel by reason of section 607(b)(1)(B) of the Act and paragraph (a)(1)(ii) of this section (relating to depreciation allowable) for any period shall be reduced by the amount (if any) which, under an agreement entered into under section 607 of the Act, the owner is required or permitted to deposit for such period with respect to such vessel by reason of section 607(b)(1)(B) of the Act and paragraph (a)(1)(ii) of this section. The amount of depreciation depositable by the lessee under this paragraph is the amount of depreciation deductible by the lessor on its income tax return, reduced by the amount described in the preceding

sentence or the amount set forth in the agreement, whichever is lower.

(f) *Definition of agreement vessel.* For purposes of this section, the term ''agreement vessel'' (as defined in § 3.11(a)(3) and 46 CFR 390.6) includes barges and containers which are the complement of an agreement vessel and which are provided for in the agreement, agreement vessels which have been contracted for or are in the process of construction, and any shares in an agreement vessel. Solely for purposes of this section, a party is considered to have a ''share'' in an agreement vessel if he has a right to use the vessel to generate income from its use whether or not the party would be considered as having a proprietary interest in the vessel for purposes of State or Federal law. Thus, a partner may enter into an agreement with respect to his share of the vessel owned by the partnership and he may make deposits of his distributive share of the sum of the four subceilings described in paragraph (a)(1) of this section. Notwithstanding the provisions of subchapter K of the Code (relating to the taxation of partners and partnerships), the Internal Revenue Service will recognize, solely for the purposes of applying this part, an agreement by an owner of a share in an agreement vessel even though the ''share'' arrangement is a partnership for purposes of the Code.

(g) *Special rules for nonmoney deposits and withdrawals*—(1) *In general.* (i) Deposits may be made in the form of money or property of the type permitted to be deposited under the agreement. (For rules relating to the types of property which may be deposited into the fund, see 46 CFR § 390.7(d), and 50 CFR part 259.) For purposes of this paragraph, the term ''property'' does not include money.

(ii) Whether or not the election provided for in subparagraph (2) of this paragraph is made—

(a) The amount of any property deposit, and the fund's basis for property deposited in the fund, is the fair market value of the property at the time deposited, and

(b) The fund's holding period for the property begins on the day after the deposit is made.

(iii) Unless such an election is made, deposits of property into a fund are considered to be a sale at fair market value of the property, a deposit of cash equal to such fair market value, and a purchase by the fund of such property for cash. Thus, in the absence of the election, the difference between the fair market value of such property deposited and its adjusted basis shall be taken into account as gain or loss for purposes of computing the party's income tax liability for the year of deposit.

(iv) For fund's basis and holding period of assets purchased by the fund, see paragraph (d) (2) and (3) of this section.

(2) *Election not to treat deposits of property other than money as a sale or exchange at the time of deposit.* A party may elect to treat a deposit of property as if no sale or other taxable event had occurred on the date of deposit. If such election is made, in the taxable year the fund disposes of the property, the party shall recognize as gain or loss the amount he would have recognized on the day the property was deposited into the fund had the election not been made. The party's holding period with respect to such property shall not include the period of time such property was held by the fund. The election shall be made by a statement to that effect, attached to the party's Federal income tax return for the taxable year to which the deposit relates, or, if such return is filed before such deposit is made, attached to the party's return for the taxable year during which the deposit is actually made.

(3) *Effect of qualified withdrawal of property deposited pursuant to election.* If property deposited into a fund, with respect to which an election under subparagraph (2) of this paragraph is made, is withdrawn from the fund in a qualified withdrawal (as defined in § 3.5) such withdrawal is treated as a disposition of such property resulting in recognition by the party of gain or loss (if any) as provided in subparagraph (2) of this paragraph with respect to nonfund property. In addition, such withdrawal is treated as a disposition of such property by the fund resulting in recognition of gain or loss by the party with respect to fund property to

the extent the fair market value of the property on the date of withdrawal is greater or less (as the case may be) than the adjusted basis of the property to the fund on such date. For purposes of determining the amount by which the balance within a particular account will be reduced in the manner provided in § 3.6(b) (relating to order of application of qualified withdrawals against accounts) and for purposes of determining the reduction in basis of a vessel, barge, or container (or share therein) pursuant to § 3.6(c), the value of the property is its fair market value on the day of the qualified withdrawal. For rules relating to the effect of a qualified withdrawal of property purchased by the fund (including deposited property considered under subparagraph (1)(iii) of this paragraph as purchased by the fund), see paragraph (d)(2)(ii) of this section.

(4) *Effect of nonqualified withdrawal of property deposited pursuant to election.* If property deposited into a fund with respect to which an election under subparagraph (2) of this paragraph is made, is withdrawn from the fund in a nonqualified withdrawal (as defined in § 3.7(b)), no gain or loss is to be recognized by the party with respect to fund property or nonfund property but an amount equal to the adjusted basis of the property to the fund is to be treated as a nonqualified withdrawal. Thus, such amount is to be applied against the various accounts in the manner provided in § 3.7(c), such amount is to be taken into account in computing the party's taxable income as provided in § 3.7(d), and such amount is to be subject to interest to the extent provided for in § 3.7(e). In the case of withdrawals to which this subparagraph applies, the adjusted basis of the property in the hands of the party is the adjusted basis on the date of deposit, increased or decreased by the adjustments made to such property while held in the fund, and in determining the period for which the party has held the property there shall be included, in addition to the period the fund held the property, the period for which the party held the property before the date of deposit of the property into the fund. For rules relating to the basis and holding period of property purchased by the fund (including deposited property considered under subparagraph (1)(ii) of this paragraph as purchased by the fund) and withdrawn in a nonqualified withdrawal see § 3.7(f).

(5) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). X Corporation, which uses the calendar year as its taxable year, maintains a fund described in § 3.1. X's taxable income (determined without regard to section 607 of the Act) is $100,000, of which $80,000 is taxable income attributable to the operation of agreement vessels (as determined under paragraph (b)(1) of this section). Under the agreement, X is required to deposit into the fund all earnings and gains received from the investment or reinvestment of amounts held in the fund, an amount equal to the net proceeds from transactions referred to in § 3.2(c), and an amount equal to 50 percent of its earnings attributable to the operation of agreement vessels provided that such 50 percent does not exceed X's taxable income from all sources for the year of deposit. The agreement permits X to make voluntary deposits of amounts equal to 100 percent of its earnings attributable to the operation of agreement vessels, subject to the limitation with respect to taxable income from all sources. The agreement also provides that deposits attributable to such earnings may be in the form of cash or other property. On March 15, 1973, X deposits, with respect to its 1972 earnings attributable to the operation of agreement vessels, stock with a fair market value at the time of deposit of $80,000 and an adjusted basis to X of $10,000. Such deposit represents agreement vessel income of $80,000. At the time of deposit, such stock had been held by X for a period exceeding 6 months. X does not elect under subparagraph (2) of this paragraph to defer recognition of the gain. Accordingly, under subparagraph (1)(iii) of this paragraph, the deposit is treated as a deposit of $80,000 and X realizes a long-term capital gain of $70,000 on March 15, 1973.

Example (2). The facts are the same as in example (1), except that X elects in accordance with subparagraph (2) of this paragraph not to treat the deposit as a sale or exchange. On July 1, 1974, the fund sells the stock for $85,000. The basis to the fund of the stock is $80,000 (see subparagraph (1)(ii) *(a)* of this paragraph). With respect to nonfund property, X recognizes $70,000 of long-term capital gain on the sale includible in its gross income for 1974. With respect to fund property, X realizes $5,000 of long-term capital gain (the difference between the amount received by the fund on the sale of the stock, $85,000, and the basis to the fund of the stock, $80,000), an amount equal to which is

required to be deposited into the fund with respect to 1974, as a gain from the investment or reinvestment of amounts held in the fund. Since the fund held the stock for a period exceeding 6 months, the $5,000 is allocated to the fund's capital gain account under § 3.4(c).

Example (3). The facts are the same as in example (2), except that the fund sells the stock on July 1, 1974, for $75,000. As the basis to the fund of the stock is $80,000, with respect to fund property, X realizes a long-term capital loss on the sale (the difference between the amount received by the fund on the sale of the stock, $75,000, and the basis to the fund of the stock, $80,000), of $5,000, an amount equal to which is required to be charged against the fund's capital gain account under § 3.4(e). Under subparagraph (2) of this paragraph, X recognizes $70,000 of long-term capital gain with respect to nonfund property on the sale which is includible in its gross income for 1974.

Example (4). The facts are the same as in example (2), except that on July 1, 1974, X makes a qualified withdrawal (as defined in § 3.5(a)) of the stock and uses it to pay indebtedness pursuant to § 3.5(b). On the disposition by X considered to occur under subparagraph (3) of this paragraph on the qualified withdrawal, X recognizes $70,000 of long-term capital gain with respect to nonfund property, which is includible in its gross income for 1974, and a long-term capital gain of $5,000 with respect to fund property, an amount equal to which is allocated to the fund's capital gain account under § 3.4(c). The fund is treated as having a qualified withdrawal of an amount equal to the fair market value of the stock on the day of withdrawal, $85,000 (see subparagraph (3) of this paragraph). In addition, $85,000 is applied against the various accounts in the order provided in § 3.6(b). The basis of the vessel with respect to which the indebtedness was incurred is to be reduced as provided in § 3.6(c).

Example (5). The facts are the same as in example (2), except that X withdraws the stock from the fund in a nonqualified withdrawal (as defined in § 3.7(b)). Under subparagraph (4) of this paragraph, X recognizes no gain or loss with respect to fund or nonfund property on such withdrawal. An amount equal to the basis of the stock to the fund ($80,000) is applied against the various accounts in the order provided in § 3.7(c), and is taken into account in computing X's taxable income for 1974 as provided in § 3.7(d). In addition, X must pay interest on the withdrawal as provided in § 3.7(e). The basis to X of the stock is $10,000 notwithstanding the fact that the fair market value of such stock was $85,000 on the day of withdrawal (see subparagraph (4) of this paragraph).

§ 3.3 Nontaxability of deposits.

(a) *In general.* Section 607(d) of the Act sets forth the rules concerning the income tax effects of deposits made with respect to ceilings described in section 607(b) and § 3.2. The specific treatment of deposits with respect to each of the subceilings is set forth in paragraph (b) of this section.

(b) *Treatment of deposits*—(1) *Earnings of agreement vessels.* Section 607(d)(1)(A) of the Act provides that taxable income of the party (determined without regard to section 607 of the Act) shall be reduced by an amount equal to the amount deposited for the taxable year out of amounts referred to in section 607(b)(1)(A) of the Act and § 3.2(a)(1)(i). For computation of the foreign tax credit, see paragraph (i) of this section.

(2) *Net proceeds from agreement vessels and fund earnings.* (i)(*a*) Section 607(d)(1)(B) provides that gain from a transaction referred to in section 607(b)(1)(C) of the Act and § 3.2(a)(1)(iii) (relating to ceilings on deposits of net proceeds from the sale or other disposition of agreement vessels) is not to be taken into account for purposes of the Code if an amount equal to the net proceeds from transactions referred to in such sections is deposited in the fund. Such gain is to be excluded from gross income of the party for the taxable year to which such deposit relates. Thus, the gain will not be taken into account in applying section 1231 of the Code for the year to which the deposit relates.

(b) [Reserved]

(ii)*(a)* Section 607(d)(1)(C) of the Act provides that the earnings (including gains and losses) from the investment and reinvestment of amounts held in the fund and referred to in section 607(b)(1)(D) of the Act and § 3.2(a)(1)(iv) shall not be taken into account for purposes of the Code if an amount equal to such earnings is deposited into the fund. Such earnings are to be excluded from the gross income of the party for the taxable year to which such deposit relates.

(b) However, for purposes of the basis adjustment under section 1232(a)(3)(E) of the Code, the ratable monthly portion of original issue discount included in gross income shall be determined

without regard to section 607(d)(1)(C) of the Act.

(iii) In determining the tax liability of a party to whom subparagraph (1) of this paragraph applies, taxable income, determined after application of subparagraph (1) of this paragraph, is in effect reduced by the portion of deposits which represent gain or earnings respectively referred to in subdivision (i) or (ii) of this subparagraph. The excess, if any, of such portion over taxable income determined after application of subparagraph (1) of this paragraph is taken into account in computing the net operating loss (under section 172 of the Code) for the taxable year to which such deposits relate.

(3) *Time for making deposits.* (i) This section applies with respect to an amount only if such amount is deposited in the fund pursuant to the agreement and not later than the time provided in subdivision (ii), (iii), or (iv) of this subparagraph for the making of such deposit or the date the Secretary of Commerce provides, whichever is earlier.

(ii) Except as provided in subdivision (iii) or (iv) of this subparagraph, a deposit may be made not later than the last day prescribed by law (including extensions thereof) for filing the party's Federal income tax return for the taxable year to which such deposit relates.

(iii) If the party is a subsidized operator under an operating-differential subsidy contract, and does not receive on or before the 59th day preceding such last day, payment of all or part of the accrued operating-differential subsidy payable for the taxable year, the party may deposit an amount equivalent to the unpaid accrued operating-differential subsidy on or before the 60th day after receipt of payment of the accrued operating-differential subsidy.

(iv) A deposit pursuant to § 3.2(a)(3)(i) (relating to underdeposits caused by audit adjustments) must be made on or before the date prescribed for such a deposit in § 3.2(a)(4).

(4) *Date of deposits.* (i) Except as otherwise provided in subdivisions (ii) and (iii) of this subparagraph (with respect to taxable years beginning after December 31, 1969, and prior to January 1, 1972), in § 3.2(a)(2)(i), or in § 3.10(b), deposits made in a fund within the time specified in subparagraph (3) of this paragraph are deemed to have been made on the date of actual deposit.

(ii)*(a)* For taxable years beginning after December 31, 1969, and prior to January 1, 1971, where an application for a fund is filed by a taxpayer prior to January 1, 1972, and an agreement is executed and entered into by the taxpayer prior to March l, 1972,

(b) For taxable years beginning after December 31, 1970, and prior to January 1, 1972, where an application for a fund is filed by a taxpayer prior to January 1, 1973, and an agreement is executed and entered into by the taxpayer prior to March l, 1973, and

(c) For taxable years beginning after December 31, 1971, and prior to January 1, 1975, where an agreement is executed and entered into by the taxpayer on or prior to the due date, with extensions, for the filing of his Federal income tax return for such taxable year,

deposits in a fund which are made within 60 days after the date of execution of the agreement, or on or before the due date, with extensions thereof, for the filing of his Federal income tax return for such taxable year or years, whichever date shall be later, shall be deemed to have been made on the date of the actual deposit or as of the close of business of the last regular business day of each such taxable year or years to which such deposits relate, whichever day is earlier.

(iii) Notwithstanding subdivision (ii) of this subparagraph, for taxable years beginning after December 31, 1970, and ending prior to January 1, 1972, deposits made later than the last date permitted under subdivision (ii) but on or before January 9, 1973, in a fund pursuant to an agreement with the Secretary of Commerce, acting by and through the Administrator of the National Oceanic and Atmospheric Administration, shall be deemed to have been made on the date of the actual deposit or as of the close of business of the last regular business day of such taxable year, whichever is earlier.

(c) *Determination of earnings and profits.* [Reserved]

(d) *Accumulated earnings tax.* As provided in section 607(d)(1)(E) of the Act amounts, while held in the fund, are

not to be taken into account in computing the ''accumulated taxable income'' of the party within the meaning of section 531 of the Code. Amounts while held in the fund are considered held for the purpose of acquiring, constructing, or reconstructing a qualified vessel or barges and containers which are part of the complement of a qualified vessel or the payment of the principal on indebtedness incurred in connection with any such acquisition, construction, or reconstruction. Thus, for example, if the reasonable needs of the business (within the meaning of section 537 of the Code) justify a greater amount of accumulation for providing replacement vessels than can be satisfied out of the fund, such greater amount accumulated outside of the fund shall be considered to be accumulated for the reasonable needs of the business. For a further example, although amounts in the fund are not taken into account in applying the tax imposed by section 531 of the Code, to the extent there are amounts in a fund to provide for replacing a vessel, amounts accumulated outside of the fund to replace the same vessel are not considered to be accumulated for the reasonable needs of the business.

(e) *Nonapplicability of section 1231.* If an amount equivalent to gain from a transaction referred to in section 607(b)(1)(C) of the Act and § 3.2(c) (1) and (5) is deposited into the fund and, therefore, such gain is not taken into account in computing gross income under the provisions of paragraph (b)(2) of this section, then such gain will not be taken into account for purposes of the computations under section 1231 of the Code.

(f) *Deposits of capital gains.* In respect of capital gains which are not included in the gross income of the party by virtue of a deposit to which section 607(d) of the Act and this section apply, the following provisions of the Code do not apply: the minimum tax for tax preferences imposed by section 56 of the Code; the alternative tax imposed by section 1201 of the Code on the excess of the party's net long-term capital gain over his net short-term capital loss; and, in the case of a taxpayer other than a corporation, the deduction provided by section 1202 of the Code of 50% of the amount of such excess. However, section 56 may apply upon a nonqualified withdrawal with respect to amounts treated under § 3.7(d)(2) as being made out of the capital gain account.

(g) *Deposits of dividends.* The deductions provided by section 243 of the Code (relating to the deductions for dividends from a domestic corporation received by a corporation) shall not apply in respect of dividends (earned on assets held in the fund) which are deposited into a fund, and which, by virtue of such deposits and the provisions of section 607(d) of the Act and this section, are not included in the gross income of the party.

(h) *Presumption of validity of deposit.* All amounts deposited in the fund shall be presumed to have been deposited pursuant to an agreement unless, after an examination of the facts upon the request of the Commissioner of Internal Revenue or his delegate, the Secretary of Commerce determines otherwise. The Commissioner or his delegate will request such a determination where there is a substantial question as to whether a deposit is made in accordance with an agreement.

(i) *Special rules for application of the foreign tax credit*—(1) *In general.* For purposes of computing the limitation under section 904 of the Code on the amount of the credit provided by section 901 of the Code (relating to the foreign tax credit), the party's taxable income from any source without the United States and the party's entire taxable income are to be determined after application of section 607(d) of the Act. Thus, amounts deposited for the taxable year with respect to amounts referred to in section 607(b)(1)(A) of the Act and § 3.2(a)(1)(i) (relating to taxable income attributable to the operation of agreement vessels) shall be treated as a deduction in arriving at the party's taxable income from sources without the United States (subject to the apportionment rules and subparagraph (2) of this paragraph) and the party's entire taxable income for the taxable year. Amounts deposited with respect to gain described in section 607(d)(1)(B) of the Act and § 3.2(c) (relating to net proceeds from the sale or other disposition of an

agreement vessel and net proceeds from insurance or indemnity) and amounts deposited with respect to earnings described in section 607(d)(1)(C) of the Act and paragraph (b)(2)(ii) (relating to earnings from the investment and reinvestment of amounts held in a fund) of this section are not taken into account for purposes of the Code and hence are not included in the party's taxable income from sources without the United States or in the party's entire taxable income for purposes of this paragraph.

(2) *Apportionment of taxable income attributable to agreement vessels.* For purposes of computing the overall limitation under section 904(a)(2) of the Code the amount of the deposit made with respect to taxable income attributable to agreement vessels pursuant to § 3.2(a)(1)(i) which is allocable to sources without the United States is the total amount of such deposit multiplied by a fraction the numerator of which is the gross income from sources without the United States from the operation of agreement vessels and the denominator of which is the total gross income from the operation of agreement vessels computed as provided in § 3.2(b)(2). For purposes of this paragraph, gross income from sources without the United States attributable to the operation of agreement vessels is to be determined under sections 861 through 863 of the Code and under the taxpayer's usual method of accounting provided such method is reasonable and in keeping with sound accounting practice. Any computation under the per-country limitation of section 904(a)(1) shall be made in the manner consistent with the provisions of the preceding sentences of this subparagraph.

§ 3.4 Establishment of accounts.

(a) *In general.* Section 607(e)(1) of the Act requires that three bookkeeping or memorandum accounts are to be established and maintained within the fund: the capital account, the capital gain account, and the ordinary income account. Deposits of the amounts under the subceilings in section 607(b) of the Act and § 3.2 are allocated among the accounts under section 607(e) of the Act and this section.

(b) *Capital account.* The capital account shall consist of:

(1) Amounts referred to in section 607(b)(1)(B) of the Act and § 3.2(a)(1)(ii) (relating to deposits for depreciation),

(2) Amounts referred to in section 607(b)(1)(C) of the Act and § 3.2(a)(1)(iii) (relating to deposits of net proceeds from the sale or other disposition of agreement vessels) other than that portion thereof which represents gain not taken into account for purposes of computing gross income by reason of section 607(d)(1)(B) of the Act and § 3.3(b)(2) (relating to nontaxability of gain from the sale or other disposition of an agreement vessel),

(3) Amounts representing 85 percent of any dividend received by the fund with respect to which the party would, but for section 607(d)(1)(C) of the Act and § 3.3(b)(2)(ii) (relating to nontaxability of deposits of earnings from investment and reinvestment of amounts held in a fund), be allowed a deduction under section 243 of the Code, and

(4) Amounts received by the fund representing interest income which is exempt from taxation under section 103 of the Code.

(c) *Capital gain account.* The capital gain account shall consist of amounts which represent the excess of (1) deposits of long-term capital gains on property referred to in section 607(b)(1) (C) and (D) of the Act and § 3.2(a)(1) (iii) and (iv) (relating respectively to certain agreement vessels and fund assets), over (2) amounts representing losses from the sale or exchange of assets held in the fund for more than 6 months (for purposes of this section referred to as ''long-term capital losses''). For purposes of this paragraph and paragraph (d)(2) of this section, an agreement vessel disposed of at a gain shall be treated as a capital asset to the extent that gain thereon is not treated as ordinary income, including gain which is ordinary income under section 607(g)(5) of the Act (relating to treatment of gain on disposition of a vessel with a reduced basis) and § 3.6(e) or under section 1245 of the Code (relating to gain from disposition of certain depreciable property). For provisions relating to the treatment of short-term capital gains on certain

transactions involving agreement vessels or realized by the fund, see paragraph (d) of this section. For rules relating to the treatment of capital losses on assets held in the fund, see paragraph (e) of this section.

(d) *Ordinary income account.* The ordinary income account shall consist of:

(1) Amounts referred to in section 607(b)(1)(A) of the Act and § 3.2(a)(1)(i) (relating to taxable income attributable to the operation of an agreement vessel),

(2) Amounts representing (i) deposits of gains from the sale or exchange of capital assets held for 6 months or less (for purposes of this section referred to as ''short-term capital gains'') referred to in section 607(b)(1) (C) or (D) of the Act and § 3.2(a)(1) (iii) and (iv) (relating respectively to certain agreement vessels and fund assets), reduced by (ii) amounts representing losses from the sale or exchange of capital assets held in the fund for 6 months or less (for purposes of this section referred to as ''short-term capital losses''). For rules relating to the treatment of certain agreement vessels as capital assets, see paragraph (c) of this section,

(3) Amounts representing interest (not including any tax-exempt interest referred to in section 607(e)(2)(D) of the Act and paragraph (b)(4) of this section) and other ordinary income received on assets held in the fund (not including any dividend referred to in section 607(e)(2)(C) of the Act and subparagraph (5) of this paragraph),

(4) Amounts representing ordinary income from a transaction (involving certain net proceeds with respect to an agreement vessel) described in section 607(b)(1)(C) of the Act and § 3.2(a)(1)(iii), including gain which is ordinary income under section 607(g)(5) of the Act and § 3.6(e) (relating to treatment of gain on the disposition of a vessel with a reduced basis) or under section 1245 of the Code (relating to gain from disposition of certain depreciable property), and

(5) Fifteen percent of any dividend referred to in section 607(e)(2)(C) of the Act and paragraph (b)(3) of this section received on any assets held in the fund.

(e) *Limitation on deduction for capital losses on assets held in a fund.* Except on termination of a fund, long-term (and short-term) capital losses on assets held in the fund shall be allowed only as an offset to long-term (and short-term) capital gains on assets held in the fund, but only if such gains are deposited into the fund, and shall not be allowed as an offset to any capital gains on assets not held in the fund. The net long-term capital loss of the fund for the taxable year shall reduce the earliest long-term capital gains in the capital gain account at the beginning of the taxable year and the net short-term capital loss for the taxable year shall reduce the earliest short-term capital gains remaining in the ordinary income account at the beginning of the taxable year. Any such losses that are in excess of the capital gains in the respective accounts shall reduce capital gains deposited into the respective accounts in subsequent years (without regard to section 1212, relating to capital loss carrybacks and carryovers). On termination of a fund, any net long-term capital loss in the capital gain account and any net short-term capital loss remaining in the ordinary income account is to be taken into account for purposes of computing the party's taxable income for the year of termination as a long-term or short-term (as the case may be) capital loss recognized in the year the fund is terminated. With respect to the determination of the basis to a fund of assets held in such fund, see § 3.2(g).

[T.D. 7398, 41 FR 5812, Feb. 10, 1976, as amended by T.D. 7831, 47 FR 39675, Sept. 9, 1982]

§ 3.5 Qualified withdrawals.

(a) *In general.* (1) A qualified withdrawal is one made from the fund during the taxable year which is in accordance with section 607(f)(1) of the Act, the agreement, and with regulations prescribed by the Secretary of Commerce and which is for the acquisition, construction, or reconstruction of a qualified vessel (as defined in § 3.11(a)(2)) or barges and containers which are part of the complement of a qualified vessel (or shares in such vessels, barges, and containers), or for the payment of the principal of indebtedness incurred in connection with the acquisition, construction, or reconstruction of such qualified vessel (or a

barge or container which is part of the complement of a qualified vessel).

(2) For purposes of this section the term *share* is used to reflect an interest in a vessel and means a proprietary interest in a vessel such as, for example, that which results from joint ownership. Accordingly, a share within the meaning of § 3.2(f) (relating to the definition of ''agreement vessel'' for the purpose of making deposits) will not necessarily be sufficient to be treated as a share within the meaning of this section.

(3) For purposes of this section, the term *acquisition* means any of the following:

(i) Any acquisition, but only to the extent the basis of the property acquired in the hands of the transferee is its cost. Thus, for example, if a party transfers a vessel and $1 million in an exchange for another vessel which qualifies for nonrecognition of gain or loss under section 1031 (a) of the Code (relating to like-kind exchange), there is an acquisition to the extent of $1 million.

(ii) With respect to a lessee's interest in a vessel, expenditures which result in increasing the amounts with respect to which a deduction for depreciation (or amortization in lieu thereof) is allowable.

(b) *Payments on indebtedness.* Payments on indebtedness may constitute qualified withdrawals only if the party shows to the satisfaction of the Secretary of Commerce a direct connection between incurring the indebtedness and the acquisition, construction, or reconstruction of a qualified vessel or its complement of barges and containers whether or not the indebtedness is secured by the vessel or its complement of barges and containers. The fact that an indebtedness is secured by an interest in a qualified vessel, barge, or container is insufficient by itself to demonstrate the necessary connection.

(c) *Payments to related persons.* Notwithstanding paragraph (a) of this section, payments from a fund to a person owned or controlled directly or indirectly by the same interests as the party within the meaning of section 482 of the Code and the regulations thereunder are not to be treated as qualified withdrawals unless the party demonstrates to the satisfaction of the Secretary of Commerce that no part of such payment constitutes a dividend, a return of capital, or a contribution to capital under the Code.

(d) *Treatment of fund upon failure to fulfill obligations.* Section 607(f)(2) of the Act provides that if the Secretary of Commerce determines that any substantial obligation under the agreement is not being fulfilled, he may, after notice and opportunity for hearing to the party, treat the entire fund, or any portion thereof, as having been withdrawn as a nonqualified withdrawal. In determining whether a party has breached a substantial obligation under the agreement, the Secretary will consider among other things, (1) the effect of the party's action or omission upon his ability to carry out the purposes of the fund and for which qualified withdrawals are permitted under section 607(f)(1) of the Act, and (2) whether the party has made material misrepresentations in connection with the agreement or has failed to disclose material information. For the income tax treatment of nonqualified withdrawals, see § 3.7.

§ 3.6 Tax treatment of qualified withdrawals.

(a) *In general.* Section 607(g) of the Act and this section provide rules for the income tax treatment of qualified withdrawals including the income tax treatment on the disposition of assets acquired with fund amounts.

(b) *Order of application of qualified withdrawals against accounts.* A qualified withdrawal from a fund shall be treated as being made: First, out of the capital account; second, out of the capital gain account; and third, out of the ordinary income account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest qualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made.

(c) *Reduction of basis.* (1) If any portion of a qualified withdrawal for the

acquisition, construction, or reconstruction of a vessel, barge, or container (or share therein) is made out of the ordinary income account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to such portion.

(2) If any portion of a qualified withdrawal for the acquisition, construction, or reconstruction of a vessel, barge, or container (or share therein) is made out of the capital gain account, the basis of such vessel, barge, or container (or share therein) shall be reduced by an amount equal to—

(i) Five-eighths of such portion, in the case of a corporation (other than an electing small business corporation, as defined in section 1371 of the Code), or

(ii) One-half of such portion, in the case of any other person.

(3) If any portion of a qualified withdrawal to pay the principal of an indebtedness is made out of the ordinary income account or the capital gain account, then the basis of the vessel, barge, or container (or share therein) with respect to which such indebtedness was incurred is reduced in the manner provided by subparagraphs (1) and (2) of this paragraph. If the aggregate amount of such withdrawal from the ordinary income account and capital gain account would cause a basis reduction in excess of the party's basis in such vessel, barge, or container (or share therein), the excess is applied against the basis of other vessels, barges, or containers (or shares therein) owned by the party at the time of withdrawal in the following order: (i) vessels, barges, or containers (or shares therein) which were the subject of qualified withdrawals in the order in which they were acquired, constructed, or reconstructed; (ii) agreement vessels (as defined in section 607(k)(3) of the Act and § 3.11(a)(3)) and barges and containers which are part of the complement of an agreement vessel (or shares therein) which were not the subject of qualified withdrawals, in the order in which such vessels, barges, or containers (or shares therein) were acquired by the party; and (iii) other vessels, barges, and containers (or shares therein), in the order in which they were acquired by the party. Any amount of a withdrawal remaining after the application of this subparagraph is to be treated as a nonqualified withdrawal. If the indebtedness was incurred to acquire two or more vessels, barges, or containers (or shares therein), then the basis reduction in such vessels, barges, or containers (or shares therein) is to be made pro rata in proportion to the adjusted basis of such vessels, barges, or containers (or shares therein) computed, however, without regard to this section and adjustments under section 1016(a) (2) and (3) of the Code for depreciation or amortization.

(d) *Basis for depreciation.* For purposes of determining the allowance for depreciation under section 167 of the Code in respect of any property which has been acquired, constructed, or reconstructed from qualified withdrawals, the adjusted basis for determining gain on such property is determined after applying paragraph (c) of this section. In the case of reductions in the basis of any property resulting from the application of paragraph (c)(3) of this section, the party may adopt a method of accounting whereby (1) payments shall reduce the basis of the property on the day such payments are actually made, or (2) payments made at any time during the first half of the party's taxable year shall reduce the basis of the property on the first day of the taxable year, and payments made at any time during the second half of the party's taxable year shall reduce the basis of the property on the first day of the succeeding taxable year. For requirements respecting the change of methods of accounting, see § 1.446–1(e)(3) of the Income Tax Regulations of this chapter.

(e) *Ordinary income treatment of gain from disposition of property acquired with qualified withdrawals.* [Reserved]

§ 3.7 Tax treatment of nonqualified withdrawals.

(a) *In general.* Section 607(h) of the Act provides rules for the tax treatment of nonqualified withdrawals, including rules for adjustments to the various accounts of the fund, the inclusion of amounts in income, and the payment of interest with respect to such amounts.

(b) *Nonqualified withdrawals defined.* Except as provided in section 607 of the Act and § 3.8 (relating to certain corporate reorganizations, changes in partnerships, and transfers by reason of death), any withdrawal from a fund which is not a qualified withdrawal shall be treated as a nonqualified withdrawal which is subject to tax in accordance with section 607(h) of the Act and the provisions of this section. Examples of nonqualified withdrawals are amounts remaining in a fund upon termination of the fund, and withdrawals which are treated as nonqualified withdrawals under section 607(f)(2) of the Act and § 3.5(d) (relating to failure by a party to fulfill substantial obligation under agreement) or under the second sentence of section 607(g)(4) of the Act and § 3.6(c)(3) (relating to payments against indebtedness in excess of basis).

(c) *Order of application of nonqualified withdrawals against deposits.* A nonqualified withdrawal from a fund shall be treated as being made: first, out of the ordinary income account; second, out of the capital gain account; and third, out of the capital account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest nonqualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. Nonqualified withdrawals for research, development, and design expenses incident to new and advanced ship design, machinery, and equipment, and any amount treated as a nonqualified withdrawal under the second sentence of section 607(g)(4) of the Act and § 3.6(c)(3), shall be applied against the deposits within a particular account on a last-in-first-out basis. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made. For special rules concerning the withdrawal of contingent deposits of net proceeds from the installment sale of an agreement vessel, see § 3.2(c)(6).

(d) *Inclusion in income.* (1) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the ordinary income account is to be included in gross income as an item of ordinary income for the taxable year in which the withdrawal is made.

(2) Any portion of a nonqualified withdrawal which, under paragraph (c) of this section, is treated as being made out of the capital gain account is to be included in income as an item of long-term capital gain recognized during the taxable year in which the withdrawal is made.

(3) For effect upon a party's taxable income of capital losses remaining in a fund upon the termination of a fund (which, under paragraph (b) of this section, is treated as a nonqualified withdrawal of amounts remaining in the fund), see § 3.4(e).

(e) *Interest.* (1) For the period on or before the last date prescribed by law, including extensions thereof, for filing the party's Federal income tax return for the taxable year during which a nonqualified withdrawal is made, no interest shall be payable under section 6601 of the Code in respect of the tax on any item which is included in gross income under paragraph (d) of this section, and no addition to such tax for such period shall be payable under section 6651 of the Code. In lieu of the interest and additions to tax under such sections, simple interest on the amount of the tax attributable to any item included in gross income under paragraph (d) of this section is to be paid at the rate of interest determined for the year of withdrawal under subparagraph (2) of this paragraph. Such interest is to be charged for the period from the last date prescribed for payment of tax for the taxable year for which such item was deposited in the fund to the last date for payment of tax for the taxable year in which the withdrawal is made. Both dates are to be determined without regard to any extensions of time for payment. Interest determined under this paragraph which is paid within the taxable year shall be allowed as a deduction for such year under section 163 of the Code. However, such interest is to be treated as part of the party's tax for the year of withdrawal for purposes of collection and in determining any interest or additions to tax for the year of withdrawal under section 6601 or 6651, respectively, of the Code.

(2) For purposes of section 607(h)(3)(C)(ii) of the Act, and for purposes of certain dispositions of vessels constructed, reconstructed, or acquired with qualified withdrawals described in § 3.6(e), the applicable rate of interest for any nonqualified withdrawal—

(i) Made in a taxable year beginning in 1970 and 1971 is 8 percent.

(ii) Made in a taxable year beginning after 1971, the rate for such year as determined and published jointly by the Secretary of the Treasury or his delegate and the Secretary of Commerce. Such rate shall bear a relationship to 8 percent which the Secretaries determine to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields for the calendar year 1970. The determination of the applicable rate for any such taxable year will be computed by multiplying 8 percent by the ratio which *(a)* the average yield on 5-year Treasury securities for the calendar year immediately preceding the beginning of such taxable year, bears to *(b)* the average yield on 5-year Treasury securities for the calendar year 1970. The applicable rate so determined shall be computed to the nearest one-hundredth of 1 percent. If such a determination and publication is made, the latest published percentage shall apply for any taxable year beginning in the calendar year with respect to which publication is made.

(3) No interest shall be payable in respect of taxes on amounts referred to in section 607(h)(2) (i) and (ii) of the Act (relating to withdrawals for research and development and payments against indebtedness in excess of basis) or in the case of any nonqualified withdrawal arising from the application of the recapture provision of section 606(5) of the Merchant Marine Act, 1936, as in effect on December 31, 1969.

(f) *Basis and holding period in the case of property purchased by the fund or considered purchased by the fund.* In the case of a nonqualified withdrawal of property other than money which was purchased by the fund (including deposited property considered under § 3.2(g)(1)(ii) as purchased by the fund), the adjusted basis of the property in the hands of the party is its adjusted basis to the fund on the day of the withdrawal. In determining the period for which the taxpayer has held the property withdrawn in a nonqualified withdrawal, there shall be included only the period beginning with the date on which the withdrawal occurred. For basis and holding period in the case of nonqualified withdrawals of property other than money deposited into the fund, see § 3.2(g)(4).

§ 3.8 Certain corporate reorganizations and changes in partnerships, and certain transfers on death. [Reserved]

§ 3.9 Consolidated returns. [Reserved]

§ 3.10 Transitional rules for existing funds.

(a) *In general.* Section 607(j) of the Act provides that any person who was maintaining a fund or funds under section 607 of the Merchant Marine Act, 1936, prior to its amendment by the Merchant Marine Act of 1970 (for purposes of this part referred to as ''old fund'') may continue to maintain such old fund in the same manner as under prior law subject to the limitations contained in section 607(j) of the Act. Thus, a party may not simultaneously maintain such old fund and a new fund established under the Act.

(b) *Extension of agreement to new fund.* If a person enters into an agreement under the Act to establish a new fund, he may agree to the extension of such agreement to some or all of the amounts in the old fund and transfer the amounts in the old fund to which the agreement is to apply from the old fund to the new fund. If an agreement to establish a new fund is extended to amounts from an old fund, each item in the old fund to which such agreement applies shall be considered to be transferred to the appropriate account in the manner provided for in § 3.8(d) in the new fund in a nontaxable transaction which is in accordance with the provisions of the agreement under which such old fund was maintained. For purposes of determining the amount of interest under section 607(h)(3)(C) of the Act and § 3.7(e), the

date of deposit of any item so transferred shall be deemed to be July 1, 1971, or the date of the deposit in the old fund, whichever is the later.

§ 3.11 Definitions.

(a) As used in the regulations in this part and as defined in section 607(k) of the Act—

(1) The term *eligible vessel* means any vessel—

(i) Constructed in the United States, and if reconstructed, reconstructed in the United States,

(ii) Documented under the laws of the United States, and

(iii) Operated in the foreign or domestic commerce of the United States or in the fisheries of the United States. Any vessel which was constructed outside of the United States but documented under the laws of the United States on April 15, 1970, or constructed outside the United States for use in the U.S. foreign trade pursuant to a contract entered into before April 15, 1970, shall be treated as satisfying the requirements of subdivision (i) of this subparagraph and the requirements of subparagraph (2)(i) of this section.

(2) The term *qualified vessel* means any vessel—

(i) Constructed in the United States and, if reconstructed, reconstructed in the United States,

(ii) Documented under the laws of the United States, and

(iii) Which the person maintaining the fund agrees with the Secretary of Commerce will be operated in the U.S. foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States.

(3) The term *agreement vessel* means any eligible vessel or qualified vessel which is subject to an agreement entered into under section 607 of the Act.

(4) The term *vessel* includes cargo handling equipment which the Secretary of Commerce determines is intended for use primarily on the vessel. The term ''vessel'' also includes an ocean-going towing vessel or an ocean-going barge or comparable towing vessel or barge operated in the Great Lakes.

(b) Insofar as the computation and collection of taxes are concerned, other terms used in the regulations in this part, except as otherwise provided in the Act or this part, have the same meaning as in the Code and the regulations thereunder.

PART 4—TEMPORARY INCOME TAX REGULATIONS UNDER SECTION 954 OF THE INTERNAL REVENUE CODE

Sec.
4.954–0 Introduction.
4.954–1 Foreign base company income; taxable years beginning after December 31, 1986.
4.954–2 Foreign personal holding company income; taxable years beginning after December 31, 1986.

AUTHORITY: 26 U.S.C. 7805.

Sec.
4.954–0 also issued under 26 U.S.C. 954 (b) and (c).
4.954–1 also issued under 26 U.S.C. 954 (b) and (c).
4.954–2 also issued under 26 U.S.C. 954 (b) and (c).

§ 4.954–0 Introduction.

(a) *Effective date.* (1) The provisions of §§ 4.954–1 and 4.954–2 apply to taxable years of a controlled foreign corporation beginning after December 31, 1986. Consequently, any gain or loss (including foreign currency gain or loss as defined in section 988(b)) recognized during such taxable years of a controlled foreign corporation is subject to these provisions. For further guidance, see § 1.954–0(a) of this chapter.

(2) The provisions of §§ 1.954A–1 and 1.954A–2 apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) for taxable years of a controlled foreign corporation beginning after December 31, 1986.*

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(1) Application of high tax exception.
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(i) Income other than foreign personal holding company income.
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(i) Income other than foreign personal holding company income.
(ii) Foreign personal holding company income.
(A) In general.
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(e) Character of an item of income.
(1) Substance of the transaction.
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(4) Coordination of categories of gross foreign base company income or gross insurance income.
(III) *§ 4.954–2 Foreign Personal Holding Company Income.*
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(5) Exclusion of rents and royalties derived in the active conduct of a trade or business.
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(4) Definition of the term ''qualified hedging transaction''.
(i) In general.
(ii) Change in purpose of hedging transaction.
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(A) In general.
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(h) Income equivalent to interest.
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§ 4.954–1 Foreign base company income; taxable years beginning after December 31, 1986.

(a) *In general*—(1) *Purpose and scope.* Section 954 (b) through (g) and §§ 1.954–1T and 1.954–2T provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952 and the regulations thereunder. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and the regulations thereunder, and thus is subject to current taxation under section 1 or 11 of the Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957 and the regulations thereunder.

(2) *Gross foreign base company income.* For taxable years of a controlled foreign corporation beginning after December 31, 1986, the gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income:

(i) Its foreign personal holding company income, as defined in section 954(c) and § 1.954–2T,

(ii) Its foreign base company sales income, as defined in section 954(d) and the regulations thereunder,

(iii) Its foreign base company services income, as defined in section 954(e) and the regulations thereunder,

(iv) Its foreign base company shipping income, as defined in section 954(f) and the regulations thereunder, and

(v) Its foreign base company oil related income, as defined in section 954(g) and the regulations thereunder.

(3) *Adjusted gross foreign base company income.* The term ''adjusted gross foreign base company income'' means the gross foreign base company income of a controlled foreign corporation as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term ''net foreign base company income'' means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions properly allocable to such income under the rules of section 954(b)(5) and paragraph (c) of this section. In computing net foreign base company income, foreign personal holding company income is reduced (but not below zero) by related person interest expense before allocating and apportioning other expenses in accordance with the rules of paragraph (c) of this section and § 1.904(d)–5(c)(2).

(5) *Adjusted net foreign base company income.* The term ''adjusted net foreign base company income'' means the net foreign base company income of a controlled foreign corporation reduced by any items of net foreign base company income for which the high tax exception of paragraph (d) of this section is elected. The term ''foreign base company income'' as used in the Code and elsewhere in the regulations generally means adjusted net foreign base company income.

(6) *Insurance income definitions.* The term ''gross insurance income'' includes any item of gross income taken into account in determining insurance income under section 953 and the regulations thereunder. The term ''adjusted gross insurance income'' means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term ''net insurance income'' means adjusted gross insurance income reduced under section 953 and the regulations thereunder so as to take into account deductions properly allocable or apportionable to such income. The term ''adjusted net insurance income'' means net insurance income reduced by any items of net insurance income for which the high tax exception of paragraph (d) of this section is elected.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income. Thus, they are not included in the gross foreign base company income or gross insurance income of the controlled foreign corporation in computing adjusted gross foreign base company income or adjusted gross insurance income (for purposes of applying the de minimis and full inclusion tests of paragraph (b) of this section).

(8) *Illustration.* The order of computation is illustrated by the following example. Computations in this paragraph (a)(8) and in paragraph (b)(5) of this section involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section.

Example. (i) *Gross income. CFC,* a controlled foreign corporation, has gross income of $1000 for the current taxable year. Of that $1000 of income, $100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2T(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), and is not excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954–2T. Another $50 is foreign base company sales income under section 954(d) and the regulations thereunder. The remaining $850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g), or 953 and the regulations thereunder, and is foreign source general limitation income described in section 904(d)(1)(I) and the regulations thereunder.

(ii) *Expenses. CFC* has expenses for the current taxable year of $500. Of that $500, $8 is from interest paid to a related person and is

allocable to foreign personal holding company income along with $2 of other expense. Another $20 of expense is allocable to foreign base company sales. The remaining $470 of expense is allocable to income other than foreign base company income or insurance income.

(iii) *Earnings and deficits. CFC* has earnings and profits for the current taxable year of $500. In the prior taxable year, *CFC* had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the subpart F income (consisting entirely of foreign source general limitation income) of *CFC* by $600 for the prior taxable year.

(iv) *Taxes.* Foreign tax of $30 is considered imposed on the interest income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of $14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of $177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have $500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows. The following steps do not illustrate the computation of the subpart F income of a controlled foreign corporation that has income from a trade or service receivable treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

Step 1—Determine gross income:

(1) Gross income $1000

Step 2—Determine gross foreign base company income and gross insurance income:

(2) Interest income included in foreign personal holding company income under section 954 (c) 100
(3) Foreign base company sales income under section 954(d) 50
(4) Total gross foreign base company income gross insurance income as defined in sections 954(c), (d), (e), (f) and (g) and 953 and the regulations thereunder (line (3) plus line (4)) 150

Step 3—Determine adjusted gross foreign base company income and adjusted gross insurance income:

(5) Five percent of gross income (.05 × line (1)) 50
(6) Seventy percent of gross income (.70 × line (1)) 700
(7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or $1,000,000).....150
(8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6)) 150

Step 4—Compute net foreign base company income:

(9) Related person interest expense and other expense allocable and apportionable to foreign personal holding company income.....10
(10) Deductions allocable and apportionable to foreign base company sales income.....20
(11) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (2) or line (7), reduced (but not below zero) by line (9)).....90
(12) Foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (3) or line (7), reduced (but not below zero) by line (10)) 30
(13) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (11) plus line (12)) 120

Step 5—Compute net insurance income:

(14) Net insurance income under section 953 and the regulations thereunder 0

Step 6—Compute adjusted net foreign base company income:

(15) Foreign tax imposed on foreign personal holding company income (as determined under paragraph (d)) 30
(16) Foreign tax imposed on foreign base company sales income (as determined under paragraph (d)).....14
(17) Ninety percent of the maximum U.S. corporate tax rate 30.6
(18) Effective rate of foreign tax imposed on foreign personal holding

company income (interest) under section 954(b)(4) and paragraph (d) (line (15) divided by line (11)) 33

(19) Effective rate of foreign tax imposed on $40 of foreign base company sales income under section 954(b)(4) and paragraph (d) (line (16) divided by line (12)) 47

(20) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (11) if line (18) is greater than line (17)) 90

(21) Foreign base company sales income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (12) if line (19) is greater than line (17)) 30

(22) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (13), reduced by the sum of line (20) and line (21)) 0

Step 7—Compute adjusted net insurance income:

(23) Adjusted net insurance income.....0

Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):

(24) Earnings and profits for the current year 500

(25) The excess in earnings and profits over subpart F income subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (24) over the sum of lines (22) and (23); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year) 500

(26) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder 600

(27) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (22), line (23), and the lesser of line (25) or line (26)) 500

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income*—(1) *De minimis rule, etc.*—(i) *In general.* If the de minimis rule of paragraph (b)(1)(ii) of this section applies, then adjusted gross foreign base company income and adjusted gross insurance income are each equal to zero. If the full inclusion rule of paragraph (b)(1)(iii) of this section applies, then adjusted gross foreign base company income consists of all items of gross income of the controlled foreign corporation other than gross insurance income, and adjusted gross insurance income consists of all items of gross insurance income. Otherwise, the adjusted gross foreign base company income of a controlled foreign corporation consists of the gross foreign base company income of the controlled foreign corporation, and the adjusted gross insurance income of a controlled foreign corporation consists of the gross insurance income of the controlled foreign corporation.

(ii) *Five percent de minimis test*—(A) *In general.* The de minimis rule of this paragraph (b)(1)(ii) applies if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

(*1*) 5 percent of gross income, or

(*2*) $1,000,000.

Controlled foreign corporations having a functional currency other than the U.S. dollar shall translate the $1,000,000 threshold using the exchange rate provided under section 989(b)(3) and the regulations thereunder for amounts included in income under section 951(a).

(B) *Coordination with section 864(d).* Gross foreign base company income or gross insurance income of a controlled foreign corporation always includes items of income from trade or service receivables described in section 864(d)(1) or (6), even if the de minimis rule of this paragraph (b)(1)(ii) is otherwise applicable. In that case, adjusted gross foreign base company income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross foreign base company income, and adjusted gross insurance income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross insurance income.

(iii) *Seventy percent full inclusion test.* The full inclusion rule of this paragraph (b)(1)(iii) applies if the sum of the foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income.

(2) *Character of items of gross income included in adjusted gross foreign base company income.* The items of gross income included in the adjusted gross foreign base company income of a controlled foreign corporation retain their character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. Items of gross income included in adjusted gross income because the full inclusion test of paragraph (b)(1)(iii) of this section is met are termed ''full inclusion foreign base company income,'' and constitute a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Items of gross foreign base company income or gross insurance income that are excluded from adjusted foreign base company income or adjusted gross insurance income because the de minimis test of paragraph (b)(1)(ii) of this section is met are potentially subject to recharacterization as adjusted net foreign base company income or adjusted net insurance income (or other categories of income included in the computation of subpart F income under section 952 and the regulations thereunder) for the taxable year under the rules of section 952(c). Items of full inclusion foreign base company income that are included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(iii) of this section is met, and are included in subpart F income under section 952 and the regulations thereunder, do not reduce amounts that, under section 952(c), are subject to recharacterization in later years on account of deficits in prior years.

(4) *Anti-abuse rule*—(i) *In general.* For purposes of applying the de minimis and full inclusion tests of paragraph (b)(1) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if one principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to avoid the application of the de minimis or full inclusion requirements of paragraph (b)(1) of this section. For purposes of this paragraph (b), a principal purpose need not be the purpose of first importance.

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to avoid the effect of the de minimis and full inclusion requirements of paragraph (b)(1) of this section if the corporations are related persons as defined in subdivision (iii) of this paragraph (b)(4) and the corporations are described in subdivision (A), (B), or (C). This presumption may be rebutted by proof to the contrary.

(A) The activities now carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were carried on, or assets that were previously held by a single controlled foreign corporation, and the United States shareholders of the controlled foreign corporations or related persons (as determined under subdivision (iii) of this paragraph (b)(4)) are substantially the same as the United States shareholders of the one controlled foreign corporation in that prior taxable year. A presumption made in connection with the requirements of this subdivision (A) of paragraph (b)(4)(ii) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of § 1.367(a)–6T(g) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and § 301.7701–3) that is a related person (as defined in subdivision (iii) of this paragraph (b)(4)) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under § 1.367(a)–6T(g)(2) if carried on directly by the United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b).

In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Illustration.* The following example illustrates the application of this paragraph (b)(4).

Example. USP is the sole United States shareholder of three controlled foreign corporations: *CFC1, CFC2* and *CFC3.* The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP,* a foreign entity classified as a partnership under section 7701(a)(2) and § 301.7701–3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP,* and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP.* Based on the facts in the table below, for their current taxable years, the foreign base company income derived by each controlled foreign corporation, including income derived from *FP,* is less than five percent of the gross income of each controlled foreign corporation and is less than $1,000,000:

	CFC1	CFC2	CFC3
Gross income	$4,000,000	$8,000,000	$12,000,000
Five percent of gross income	200,000	400,000	600,000
Foreign base company income	199,000	398,000	597,000

Thus, without the application of the anti-abuse rule of this subparagraph (5), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis rule of section 954(b)(3)(A) and § 1.954–1T(b)(1).

However, under these facts the requirements of subdivision (i) of this paragraph (b)(4) are presumed to be met. The sum of the foreign base company income of the controlled foreign corporations is $1,194,000. Thus, the amount of adjusted gross foreign base company income will not be less than the amount of gross foreign base company income by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(5) *Illustration.* The following example illustrates computations required by sections 952 and 954 and this § 1.954–1T if the full inclusion test of paragraph (b)(1)(iii) is met (see paragraph (a)(8) for an example illustrating computations required if the de minimis test of paragraph (b)(1)(ii) is met):

Example. (i) *Gross Income. CFC,* a controlled foreign corporation, has gross income of $1,000 for the current taxable year. Of that $1,000 of income, $720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2T(b)(ii), is not income from trade or service receivables described in section 864(d) (1) or (6), and is not excluded from foreign personal holding company income under any provisions of section 954(c) and § 1.954–2T. The remaining $280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g) or 953 and the regulations thereunder, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses. CFC* has expenses for the current taxable year of $650. Of that $650, $350 is from interest paid to related persons that is allocable to foreign personal holding company income along with $50 of other expense. The remaining $250 of expense is allocable to services income other than foreign base company income or insurance income.

(iii) *Earnings and deficits. CFC* has earnings and profits for the current taxable year of $350. In the prior taxable year, *CFC* had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the subpart F income of *CFC* (consisting entirely of foreign source general limitation income) by $600 for the prior taxable year.

(iv) *Taxes.* A foreign tax of $120 is considered imposed on the $720 of interest income under the rules of section 954(b)(4) and paragraph (d) of this section, and a foreign tax of $2 is considered imposed on the services income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have $350 of subpart F income as defined in section 952(a) determined as follows:

Step 1—Determine gross income:

(1) Gross income $1000

Step 2—Compute gross foreign base company income and gross insurance income:

(2) Gross foreign base company income and insurance income as defined in sections 954(c), (d), (e), (f), (g) and 953 and the regulations thereunder (interest income).....720

Step 3—Compute adjusted gross foreign base company income:

(3) Seventy percent of gross income (.70 × line (1)) 700

(4) Adjusted gross foreign base company income or insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)) 1000

(5) Full inclusion foreign base company income under paragraph (a)(2)(vi) (line (4) minus line (2)) 280

Step 4—Compute net foreign base company income:

(6) Related person interest expense and other deductions allocable and apportionable to foreign personal holding company income under section 954(b)(5) and paragraph (c) 400

(7) Deductions allocable and apportionable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) 250

(8) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced (but not below zero) by line (6)) 320

(9) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) paragraph (c) of this section (line (5) reduced (but not below zero) by line (7)) 30

(10) Total gross foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (8) plus line (9)) 350

Step 5—Compute net insurance income:

(11) Net insurance income under section 953 and the regulations thereunder 0

Step 6—Compute adjusted net foreign base company income:

(12) Foreign tax imposed on foreign personal holding company income (interest) 120

(13) Foreign tax imposed on full inclusion foreign base company income 2

(14) Ninety percent of the maximum U.S. corporate tax rate 30.6

(15) Effective rate of foreign tax imposed on $320 of foreign personal holding company income under section 954(b)(4) and paragraph (d) (line (12) divided by line (8)).....38

(16) Effective rate of foreign tax imposed of $30 of full inclusion foreign base company income under section 954(b)(4) and paragraph (d) (line (13) divided by line (9)) 7

(17) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (8) if line (15) is greater than line (14)) 320

(18) Full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (9) if line (16) is greater than line (14)) 0

(19) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (10), reduced by the sum of line (17) and line (18)) 30

Step 7—Compute adjusted net insurance income:

(20) Adjusted net insurance income.....0

Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):

(21) Earnings and profits for the current year 350

(22) The excess in earnings and profits over subpart F income, which is subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (21) over the sum of line (19) and line (20)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year 320

(23) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder 600

(24) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (19) and line (20) plus the lesser of line (22) or line (23)) 350

(25) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years

under section 952(c) (excess of line (23) over line (22)) 280

(c) *Computation of net foreign base company income*—The net foreign base company income of a controlled foreign corporation is computed by reducing (but not below zero) the amount of gross income in each of the categories of adjusted gross foreign base company income described in paragraph (b)(2) of this section, so as to take into account deductions allocable and apportionable to such income. For purposes of section 954 and this section, expenses must be allocated and apportioned consistent with the allocation and apportionment of expenses for purposes of section 904(d). For purposes of this § 1.954–1T, an item of net foreign base company income must be categorized according to the category of adjusted gross foreign base company income from which it is derived. Thus, an item of net foreign base company income must be categorized as a net item of—

(1) Foreign personal holding company income,

(2) Foreign base company sales income,

(3) Foreign base company services income,

(4) Foreign base company shipping income,

(5) Foreign base company oil related income, or

(6) Full inclusion foreign base company income.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income*—(1) *Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any item of such income (other than foreign base company oil related income as defined in section 954(g)) subject to the high tax exception provided by section 954(b)(4) and this paragraph (d). An item of income is subject to the high tax exception only if—

(i) It is established that the income was subject to creditable income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 or 15 for the taxable year of the controlled foreign corporation; and

(ii) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income.

See paragraph (d)(4) of this section for the definition of the term ''item of income.'' For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see § 904–1.4(c)(1).

(2) *Effective rate at which taxes are imposed.* For purposes of this paragraph (d), the effective rate at which taxes are imposed on an item of income is—

(i) The amount of income taxes paid or accrued (or deemed paid or accrued) with respect to the item of income, determined under paragraph (d)(3) of this section, divided by

(ii) The item of net foreign base company income or net insurance income, determined under paragraph (d)(4) of this section (including the appropriate amount of income taxes referred to in subdivision (i) of this paragraph (d)(2), immediately above).

(3) *Taxes paid or accrued with respect to an item of income*—(i) *Income other than passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of income (other than an item of foreign personal holding company income that is passive income) for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a U.S. shareholder under section 951(a)(1)(A). For this purpose, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a).

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of foreign personal holding company income that is passive income for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes paid or accrued or deemed paid by the foreign corporation

that would be taken into account for purposes of applying the provisions of § 1.904–4(c) with respect to that item of income.

(4) *Item of income*—(i) *Income other than passive foreign personal holding company income.* The high tax exception applies (when elected) to all income that constitutes a single item under this paragraph (d)(4). A single item of net foreign base company income or net insurance income is an amount of net foreign base company income (other than foreign personal holding company income that is passive income) or net insurance income that:

(A) Falls within a single category of net foreign base company income, as defined in paragraph (c) of this section, or net insurance income, and

(B) Also falls within a single separate limitation category for purposes of sections 904(d) and 960 and the regulations thereunder.

(ii) *Passive foreign personal holding company income*—(A) *In general.* For purposes of this paragraph (d) a single item of net foreign personal holding company income that is passive income is an amount of such income that falls within a single group of passive income under the grouping rules of § 1.904–4(c) (3), (4), and (5).

(B) *Consistency rule.* An election to exclude income from subpart F must be consistently made with respect to all items of passive foreign personal holding company income eligible to be excluded. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation must be excluded in its entirety, or remain subject to subpart F.

(5) *Procedure.* The election provided by this paragraph (d) must be made—

(i) By controlling United States shareholders, as defined in § 1.964–1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by subsequent administrative pronouncements, or

(ii) In such other manner as may be prescribed in subsequent administrative pronouncements.

An election made under the procedure provided by this paragraph (d)(5) is binding on all United States shareholders of the controlled foreign corporation.

(6) *Illustrations.* The rules of this paragraph (d) are illustrated by the following examples.

Example 1. (i) *Items of income.* During its 1987 taxable year, controlled foreign corporation CFC receives from outside its country of operation portfolio dividend income of $100 and interest income of $100 (consisting of a gross payment of $150 reduced by a third-country withholding tax of $50). For purposes of illustration, assume that the CFC incurs no expenses. None of the income is taxed in CFC's country of operation. The dividend income was not subject to their-country withholding taxes. The interest income was subject to withholding taxes equal to $50, and is therefore high withholding tax interest for purposes of section 960 (pursuant to the operation of section 904). The dividend income is passive income for purposes of section 960. Accordingly, pursuant to paragraph (d)(4) of this section, CFC has two items of income: (1) $100 of FPHC/passive income (the dividends) and (2) $100 of FPHC/high withholding tax income (the interest). The election under paragraph (d)(5) of this section to exclude high-taxed income from the operation of subpart F is potentially applicable to each such item in its entirety.

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to item (1). Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F under the rules of this paragraph (d). Foreign tax of $50 would be deemed paid under section 960 with respect to item (2). Therefore, the effective rate of foreign tax is 33 percent ($50 of creditable taxes paid, divided by $150, consisting of the item of net foreign base company income ($100) plus creditable taxes paid thereon ($50). The highest rate of tax specified in section 11 for the 1987 taxable year is 34 percent. Accordingly, item (2) may be excluded from subpart F pursuant to an election under paragraph (d)(5) of this section, since it is subject to foreign tax at an effective rate that is greater than 30.6 percent (90 percent of 34 percent). However, it remains high withholding tax interest when included.

Example 2. The facts are the same as in Example 1, except that CFC's country of operation imposes a tax of $50 with respect to CFC's dividend income. The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) $100 of FPHC/high withholding tax interest income, and (2) $50 of FPHC/passive income (net of the $50 foreign tax). Both items are taxed at

an effective rate greater than 31.6 percent. Item 1: Foreign tax ($50) divided by sum ($150) of income item ($100) plus creditable tax thereon ($50) equals 33 percent. Item 2: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either, both, or neither of items 1 and 2 from subpart F.

Example 3. The facts are the same as in Example 1, except that the $100 of portfolio dividend income is subject to a third-country withholding tax of $50, and the $150 of interest income is from sources within CFC's country of operation, is subject to a $10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (d)(4)(ii)(A) of this section they constitute separate items of income pursuant to the application of the grouping rules of §1.904–4(c). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) $50 (net of tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and (2) $140 (net of $10 tax) of FPHC/country of operation income. Item 1 is taxed at an effective rate greater than 30.6 percent, but Item 2 is not. Item 1: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Item 2: Foreign tax ($10) divided by sum ($150) of income item ($140) plus creditable tax thereon ($10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude Item 1 but not Item 2 from subpart F.

Example 4. The facts are the same as in Example 3, except that the $150 of interest income is subject to an income tax of $50 in CFC's country of operation. Accordingly, CFC has two items of income, as in Example 4, but both items are taxed at an effective rate greater than 30.6 percent. Item 1: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Item 2: Foreign tax ($50) divided by sum ($150) if income item ($100) plus creditable tax thereon ($50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(ii)(B) of this section, CFC's shareholders must consistently elect or not elect to exclude from subpart F all items of FPHC income that are eligible to be excluded. Therefore, an election may be made to exclude both Item 1 and Item 2 from subpart F, or neither may be excluded.

(e) *Character of an item of income*—(1) *Substance of the transaction.* For purposes of section 954 and the regulations thereunder, items of income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount received as ''rent'' which actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as ''rent'' but shall be characterized as income from the sale of property, royalties or income from services, respectively. Local law shall not be controlling in characterizing an item of income.

(2) *Separable character.* To the extent one of the definitional provisions of section 953 or 954 describes a portion of the income or gain derived from a transaction, that portion of income or gain is so characterized. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing and selling personal property, receives interest (including imputed interest and market discount) on an account receivable arising from a sale, a portion of the income derived from the transaction by the controlled foreign corporation will be interest, and another portion will be gain (or loss) from the sale of personal property. If the sale is denominated in a currency other than a functional currency as defined in section 985 and the regulations thereunder, the controlled foreign corporation may have additional income in the form of foreign currency gain as defined in section 988.

(3) *Predominant character.* The portion of income derived from a transaction that meets the definition of foreign personal holding company income is always separately determinable, and thus must always be segregated from other income and separately classified under paragraph (2) of this paragraph (e). However, the portion of income derived from a transaction that would meet a particular definitional provision under section 954 or 953 and the regulations thereunder (other than the definition of foreign personal holding company income) in unusual circumstances may be indeterminable. If such portion is indeterminable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled

foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise indeterminable, then the classification of income from the transaction shall be made in accordance with the predominant character of the particular integrated arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income.* The definitions of gross foreign base company income and gross insurance income are limited by the following rules (to be applied in numerical order):

(i) If an item of income is included in subpart F income under section 952(a)(1) and the regulations thereunder as insurance income, it is by definition excluded from any other category of subpart F income.

(ii) If an item of income is included in the foreign base company oil related income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivision (i) of this paragraph (e)(4).

(iii) If an item of income is included in the foreign base company shipping income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivisions (i) and (ii) of this paragraph (e)(4).

(iv) If an item of income is included in foreign personal holding company income of a controlled foreign corporation, it is by definition not included in any other category of foreign base company income, other than as provided in subdivisions (i), (ii), and (iii) of this paragraph (e)(4).

An item of income shall not be excluded from the definition of a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in the general definition of another category of gross foreign base company income or gross insurance income, if the item of income is excluded from that other category by a more specific provision of section 953 or 954 and the regulations thereunder. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under § 1.954–2T(f) as income from qualified active sales may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See § 1.954–2T(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

[T.D. 8216, 53 FR 27492, July 21, 1988. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

§ 4.954–2 Foreign Personal Holding Company Income; taxable years beginning after December 31, 1986.

(a) *Computation of foreign personal holding company income*—(1) *In general.* Foreign personal holding company income consists of the following categories of income:

(i) Dividends, interest, rents, royalties, and annuities as defined in paragraph (b) of this section;

(ii) Gain from certain property transactions as defined in paragraph (e) of this section;

(iii) Gain from commodities transactions as defined in paragraph (f) of this section;

(iv) Foreign currency gain as defined in paragraph (g) of this section; and

(v) Income equivalent to interest as defined in paragraph (h) of this section.

Paragraph (a)(3) of this section provides rules for determining the use or purpose for which property is held, if a change in use or purpose would affect the computation of foreign personal holding company income under paragraphs (e), (f), and (g) of this section. Paragraphs (c) and (d) of this section provide rules for determining certain rents and royalties that are excluded from foreign personal holding company income under paragraph (b) of this section.

(2) *Coordination of overlapping definitions.* If a particular portion of income from a transaction in substance falls within more than one of the definitional rules of section 954(c) and this section, its character is determined under the rules of subdivision (i)

through (iii) of this paragraph (a)(2). The character of loss from a transaction must be similarly determined under the rules of this paragraph (a)(2).

(i) If a portion of the income from a transaction falls within the definition of income equivalent to interest under paragraph (h) of this section and the definition of gain from certain property transactions under paragraph (e) of this section, gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), or foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction), that portion of income is treated as income equivalent to interest for purposes of section 954(c) and this section.

(ii) If a portion of the income from a transaction falls within the definition of foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction) and the definition of gain from certain property transactions under paragraph (e) of this section, or gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), that portion of income is treated as foreign currency gain for purposes of section 954(c) and this section.

(iii) If a portion of the income from a transaction falls within the definition of gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales) and the definition of gain from certain property transactions under paragraph (e) of this section, that portion of income is treated as gain from a commodities transaction for purposes of section 954(c) and this section.

(3) *Changes in the use or purpose with which property is held*—(i) *In general.* Under paragraphs (e), (f), and (g) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. For purposes of this section, in determining the purpose or use for which property is held, the period shortly before disposition is the most significant period. However, if a controlled foreign corporation held property with a purpose that would have caused its disposition to give rise to gain or loss included in the computation of foreign personal holding company income under this section, and prior to disposition the controlled foreign corporation changed the purpose or use for which it held the property to one that would cause its disposition to give rise to gain or loss excluded from the computation of foreign personal holding company income, then the later purpose or use shall be ignored unless it was continuously present for a predominant portion of the period during which the controlled foreign corporation held the property. Under paragraph (g)(4)(iii) of this section, a currency hedging transaction may be treated as two or more separate hedging transactions, such that each portion is separately considered in applying this paragraph (a)(3).

(ii) *Illustrations.* The following examples illustrate the application of this paragraph (a)(3).

Example 1. At the beginning of taxable year 1, *CFC,* a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, *CFC* derives rents from this building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, *CFC* changes the use of the building by terminating all leases, and using it in an active trade or business. At the beginning of taxable year 4, *CFC* sells the building at a gain. For purposes of paragraph (e) of this section (gains from the sale or exchange of certain property) the building is considered to be property that gives rise to rents, as described in paragraph (e)(2). Because there was a change of use at the beginning of year 3 that would cause the disposition of the building to give rise to gain or loss excluded from the computation of foreign personal holding company income, the characterization of the gain derived at the beginning of year 4 is determined according to the property's use during the predominant portion of the period from purchase to date of sale. Therefore, gain from the sale of that building is included in the computation of foreign

personal holding company income under paragraph (e) of this section.

Example 2. For taxable years 1, 2, and 3, *CFC,* a controlled foreign corporation, is engaged in the active conduct of a commodity business as a handler of gold, as defined in paragraph (f)(3)(iii), and substantially all of its business is as an active handler of gold, as defined in paragraph (f)(3)(iv). At the beginning of taxable year 1, *CFC* purchases 1000 ounces of gold for investment. At the beginning of taxable year 3, *CFC* begins holding that gold in physical form for sale to customers. During taxable year 3, *CFC* sells the entire 1000 ounces of gold in transactions described in paragraph (f)(3)(ii) at a gain. For purposes of paragraph (f), *CFC* is considered to hold the gold for investment, and not in its capacity as an active handler of gold. Thus, under paragraph (f)(3)(i), the gold is not considered to be sold in the active trade or business of the *CFC* as a handler of gold, and gain from the sale is included in the computation of foreign personal holding company income under paragraph (f) of this section.

Example 3. CFC, a controlled foreign corporation, is a regular dealer in unimproved land. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* enters into an agreement with A to pay $100 for certain real property to be held by *CFC* for investment. On day 10, under its method of accounting, *CFC* accrues the value of $100 in country X currency, but payment will not be made until the first day of the next taxable year (day 366). On day 190, *CFC* determines to hold the property for sale to customers in a transaction that would be a qualified business transaction under paragraph (g)(3) of this section. For purposes of this section, the land is considered to be held for investment, and the foreign currency gain attributable to that transaction is included in the computation of foreign personal holding company income under paragraph (g) of this section.

Example 4. CFC, a controlled foreign corporation, is a regular dealer in widgets. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* sells widgets held in inventory to A for delivery on day 60. The sales price is denominated in U.S. dollars, and payment is to be made by A on the same day the widgets are to be delivered to A. The remaining facts and circumstances are such that this sale would meet the definition of a qualified business transaction under paragraph (g)(4), the foreign currency gain from which would be excluded from the computation of foreign personal holding company income under paragraph (g). On day 1, *CFC* sells U.S. dollars forward for delivery in 60 days in a transaction that would be a qualified hedging transaction under paragraph (g)(5). On day 25 the sale of widgets to A is cancelled in a transaction that does not result in *CFC* realizing any foreign currency gain or loss with respect to the sale of widgets. However, *CFC* holds the dollar forward contract to maturity. Because the forward contract does not hedge a qualified business transaction during the period shortly before its maturity, it is not to be considered a qualified hedging transaction under paragraph (g), and any foreign currency gain or loss recognized therefrom is included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the foreign currency gain or loss derived from the forward contract that is attributable to days 1 through 25, and the portion that is attributable to days 25 through 60, the forward contract may be considered two separate transactions in accordance with the rules provided by paragraph (g)(4)(ii) of this section. Thus, the forward sale may be separately considered a qualified hedging transaction for day 1 through day 25, and the foreign currency gain or loss attributable to day 1 through day 25 may be excluded from the computation of foreign personal holding company income under paragraph (g) of this section.

Example 5. CFC, a controlled foreign corporation, has country X currency as its functional currency under section 985 and the regulations thereunder. On day 1 of the current taxable year, *CFC,* speculating on exchange rates, sells dollars forward for delivery in 120 days. On day 65, *CFC* sells widgets held in inventory at a price denominated in dollars to be paid on day 120 in a transaction that is a qualified business transaction. *CFC* had not made any other dollar sales between day 1 and day 65 and does not anticipate making any other dollar sales during the taxable year. On day 65, *CFC* accrues the value of $100 in country X currency. On day 120, *CFC* receives $100 payment for the widgets and recognizes foreign currency loss pursuant to that transaction. On day 120 *CFC* also delivers dollars in connection with the forward sale, and recognizes foreign currency gain pursuant to the delivery. Under this paragraph (a)(3) the currency transaction is considered to have been entered into for speculation, and any currency gain recognized by *CFC* on the forward sale of dollars must be included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the forward sale, and the foreign currency gain or therefrom, that is attributable to day 1 through day 64, and the portion that is attributable to day 65 through day 120, the forward sale may be considered two separate transactions in accordance with the rules provided by paragraph

(g)(4)(ii) of this section. Thus, the transaction for day 65 through day 120 may be considered a separate transaction that is a qualified hedging transaction, and the foreign currency gain attributable to day 65 through day 120 may be excluded from the computation of foreign personal holding company income under this paragraph (g) if all the other requirements for treatment as a qualified hedging transaction under paragraph (g) are met.

(4) *Definitions.* The following definitions apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term ''interest'' includes amounts that are treated as ordinary income, original issue discount or interest income (including original issue discount and interest on a tax-exempt obligation) by reason of sections 482, 483, 864(d), 1273, 1274, 1276, 1281, 1286, 1288, 7872 and the regulations thereunder, or as interest or original issue discount income by reason of any other provision of law. For special rules concerning interest exempt from U.S. tax pursuant to section 103, see paragraph (b)(6) of this section.

(ii) *Inventory and similar property.* The term ''inventory and similar property'' (or ''inventory or similar property'') means property that is stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled corporation if on hand at the close of the taxable year (were the controlled foreign corporation a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business. Rights to property held in bona fide hedging transactions that reduce the risk of price changes in the cost of ''inventory and similar property'' are included in the definition of that term if they are an integral part of the system by which a controlled foreign corporation purchases such property, and they are so identified by the close of the fifth day after the day on which the hedging transaction is entered into.

(iii) *Regular dealer.* The term ''regular dealer'' means a merchant with an established place of business that—

(A) Regularly and actively engages as a merchant in purchasing property and selling it to customers in the ordinary course of business with a view to the gains and profits that may be derived therefrom, or

(B) Makes a market in derivative financial products of property (such as forward contracts to buy or sell property, option contracts to buy or sell property, interest rate and currency swap contracts or other national principal contracts) by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business.

Purchasing and selling property through a regulated exchange or established off-exchange market (for example, engaging in futures transactions) is not actively engaging as a merchant for purposes of this section.

(iv) *Dealer property.* Property held by a controlled foreign corporation is ''dealer property'' if—

(A) The controlled foreign corporation is a regular dealer in property of such kind, and

(B) The property is held by the controlled foreign corporation in its capacity as a dealer.

Property which is held by the controlled foreign corporation for investment or speculation is not such property.

(v) *Debt instrument.* The term ''debt instrument'' includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

(b) *Dividends, etc.*—(1) *In general.* Foreign personal holding company includes:

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(3) of this section and distributions of previously taxed income under section 959(b) and the regulations thereunder;

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(3) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in (b)(4) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(5); and

(iv) Annuities.

(2) *Exclusion of certain export financing*—(i) *In general.* Pursuant to section 954(c)(2)(B), foreign personal holding company income computed under section 954(c)(1)(A) and this paragraph (b) does not include interest that is export financing interest. For purposes of section 954(c)(2)(B) and this section, the term ''export financing interest'' means interest that is derived in the conduct of a banking business and is export financing interest as defined in section 904(d)(2)(G) and the regulations thereunder. Pursuant to section 864(d)(5)(A)(iii), it does not include income from related party factoring that is treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

(ii) *Conduct of a banking business.* For purposes of this section, export financing interest as defined in section 904(d)(2)(G) and the regulations thereunder is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

(iii) *Illustration.* The following example illustrates the application of this provision:

Example. DS, a domestic corporation, manufactures property in the United States. In addition to selling inventory (property described in section 1221(1)), *DS* occasionally sells depreciable equipment it manufactures for use in its trade or business, which is property described in section 1221(2). Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G) and the regulations thereunder, of each item of inventory or equipment sold by *DS* is attributable to products imported into the United States. *CFC,* a controlled foreign corporation related (as defined in section 954(d)) to *DS,* provides loans for the purchase of property from *DS,* if the property is purchased exclusively for use of consumption outside the United States.

If, in issuing and servicing loans made with respect to purchases from *DS* of depreciable equipment used in its trade or business, which is property described in section 1221(2) in the hands of *DS, CFC* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of paragraph (b)(2) of this section, which would not be included in foreign personal holding company income under section 954(c) and paragraph (b)(1)(ii) of this section. However, interest from the loans made with respect to purchases from *DS* of property which is inventory in the hands of *DS* cannot be export financing interest because it is treated as income from a trade or service receivable under section 864(d)(6) and the regulations thereunder, and thus is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section. See § 1.864–8T(d) for rules concerning certain income from trade and service receivables qualifying under the same country exception of section 864(d)(7).

(3) *Exclusion of dividends and interest from related persons*—(i) *Excluded dividends and interest.* Foreign personal holding company income does not include dividends and interest if—

(A) The payor is a corporation that is a related person as defined in section 954(a)(3),

(B) The payor is created or organized (''incorporated'') under the laws of the same foreign country as the controlled foreign corporation, and

(C) A substantial part of the payor's assets are used in a trade or business in the payor's country of incorporation as determined under subdivision (iv) of this paragraph (b)(3).

Except as otherwise provided under this paragraph (b)(3), the principles of section 367(a) and regulations thereunder shall apply in determining whether the payor has a trade or business in its country of incorporation, and whether its assets are used in that trade or business.

(ii) *Interest paid out of adjusted foreign base company income or insurance income.* Interest may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(3) to the extent that the deduction for the interest is allocated under § 1.954–1T(c) to the payor's adjusted gross foreign base company income (as defined in § 1.954–1T(a)(3)), adjusted gross insurance income (as defined in § 1.954–1T(a)(6)), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in § 1.954–

1T(a)(4), net insurance income (as defined in § 1.954–1T(a)(6)), or income described in sections 952(a) (3), (4), and (5).

(iii) *Dividends paid out of prior years' earnings.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(3) only to the extent they are paid out of earnings and profits which were earned or accumulated during a period in which the requirements of subdivision (i) of this paragraph (b)(3) were satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payor was a related corporation as to be controlled foreign corporation and the other requirements of subdivision (i) of this paragraph (b)(3) are substantially satisfied.

(iv) *Fifty percent substantial assets test.* A substantial part of the assets of the payor will be considered used in a trade or business located in its country of incorporation only if, for each quarter during such taxable year, the average value (as of the beginning and end of the quarter) of its assets which are used in the trade or business and are located in such country constitutes over 50 percent of the average value (as of the beginning and end of the quarter) of all the assets of the payor (including assets not used in a trade or business). For such purposes the value of assets shall be determined under subdivision (v) of this paragraph (b)(3), and the location of assets used in a trade or business of the payor shall be determined under subdivisions (vi) through (xi) of this paragraph (b)(3).

(v) *Value of assets.* For purposes of determining whether a substantial part of the assets of the payor are used in a trade or business in its country of incorporation, the value of assets shall be their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(vi) *Location of tangible property used in a trade or business*—(A) *In general.* Tangible property (other than inventory and similar property) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* If tangible personal property used in a trade or business is intended for use in the payor's country of incorporation, but is temporarily located elsewhere, it will be considered located within payor's country of incorporation if the reason for its location elsewhere is for inspection or repair, and it is not currently in service in a country other than the payor's country of incorporation and is not to be placed in service in a country other than the payor's country of incorporation following the inspection or repair.

(vii) *Location of intangible property used in a trade or business*—(A) *In general.* The location of intangible property (other than inventory or similar property and debt instruments) used in a trade or business is determined based on the site of the activities conducted by the payor during the current year in connection with using or exploiting that property. An item of intangible property is located in the payor's country of incorporation during each quarter of the current taxable year if the activities connected with its use or exploitation are conducted during the entire current taxable year by the payor in its country of incorporation. For this purpose, the determination of the country in which services are performed shall be made under the principles of section 954(e) and § 1.954–4(c).

(B) *Property located in part in the payor's country of incorporation and in part in other countries.* If the activities connected with the use or exploitation of an item of intangible property are conducted during the current taxable year by the payor in the payor's country of incorporation and in other countries, then a percentage of the intangible (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation during each quarter. That percentage equals the ratio that the expenses of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to the expenses of the payor incurred during the entire taxable year by reason of all

such activities worldwide. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the computation provided by this paragraph (b)(3) if they are deductible under section 162 or includible in inventory costs or the costs of goods sold (were the payor a domestic corporation).

(viii) *Location of property held for sale to customers*—(A) *In general.* Inventory or similar property is considered located in the payor's country of incorporation during each quarter of the taxable year if the activities of the payor in connection with the production and sale, or purchase and release, of such property and conducted in the payor's country of incorporation during the entire taxable year. If the payor conducts such activities through an independent contractor, then the location of such activities shall be the place in which they are conducted by the independent contractor.

(B) *Inventory located in part in the payor's country of incorporation and in part in other countries.* If the activities connected with the production and sales, or purchase and resale, of inventory or similar property are conducted by the payor in the payor's country of incorporation and other countries, then a percentage of the inventory or similar property (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation each quarter. That percentage equals the ratio that the costs of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to all such costs incurred by reason of such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property is included in this computation if it—

(*1*) Must be included in inventory costs or otherwise capitalized with respect to inventory or similar property under section 61, 263A, 471, or 472 and the regulations thereunder (whichever would be applicable were the payor a domestic corporation), or

(*2*) Would be deductible under section 162 (were the payor a domestic corporation) and is definitely related to gross income derived from such property (but not to all classes of gross income derived by the payor) under the principles of § 1.861–8.

(ix) *Location of debt instruments.* For purposes of this paragraph (b)(3), debt instruments are considered to be used in a trade or business only if they arise from the sale of inventory or similar property by the payor or from the rendition of services by the payor in the ordinary course of a trade or business of the payor, but only until such time as interest is required to be charged under section 482 and the regulations thereunder. Debt instruments that arise from the sale of inventory or similar property are treated as having the same location, proportionately, as inventory or similar property that is held during the same calendar quarter. Debt instruments arising from the rendition of services in the ordinary course of a trade or business are considered located on a proportionate basis in the countries in which the services to which they relate are performed.

(x) *Treatment of certain stock interests.* For the purpose of determining the value of assets used in a trade or business in the country of incorporation, stock directly or indirectly owned by the payor within the meaning of section 958(a) in a controlled foreign corporation (''lower-tier corporation''), which is incorporated in the same country as the payor, shall be considered located in the country of incorporation and used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorporation. The location of assets used in a trade or business of the lower-tier corporation shall be determined under the rules of this paragraph (b)(3).

(xi) *Determination of period during which property is used in a trade or business.* Property purchased or produced for use in a trade or business shall not be considered used in a trade or business until it is placed in service, and shall cease to be considered used in a trade or business when it is retired from service. The dates during which depreciable property is determined to

be in use must be consistent with the determination of depreciation under sections 167 and 168 and the regulations thereunder.

(xii) *Treatment of banks and insurance companies.* [Reserved.]

(4) *Exclusion of rents and royalties derived from related persons*—(i) *In general.* Foreign personal holding company income does not include rents or royalties if—

(A) The payor is a corporation that is a related person as defined in section 954(d)(3), and

(B) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the recipient of the payments is created or organized.

If the property is used both within and without the country under the laws of which the controlled foreign corporation is created or organized, the part of the rent or royalty attributable to the use of, or the privilege of using, the property outside such country of incorporation is, unless otherwise provided, foreign personal holding company income under this paragraph (b).

(ii) *Rents or royalties paid out of adjusted foreign base company income or insurance income.* Rents or royalties may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(4) to the extent that deductions for the payments are allocated under section 954(b)(5) and §1.954–1T(a)(4) to the payor's adjusted gross foreign base company income (as defined in §1.954–1T(a)(3)), adjusted gross insurance income (as defined in §1.954–1T(a)(6), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in §1.954–1T(a)(4)), net insurance income (as defined in §1.954–1T(a)(6)), or income described in section 952(a) (3), (4), or (5).

(5) *Exclusion of rents and royalties derived in the active conduct of a trade or business.* Foreign personal holding company income shall not include rents or royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person within the meaning of section 954(d)(3). Whether or not rents or royalties are derived in the active conduct of a trade or business is to be determined from the facts and circumstances of each case; but see paragraph (c) or (d) of this section for specific cases in which rents or royalties will be considered for purposes of this paragraph to be derived in the active conduct of a trade or business. The frequency with which a foreign corporation enters into transactions from which rents or royalties are derived will not of itself establish the fact that such rents or royalties are derived in the active conduct of a trade or business.

(6) *Treatment of tax exempt interest.* Foreign personal holding company income includes all interest income, including interest that is exempt from U.S. tax pursuant to section 103 (''tax-exempt interest''). However, that net foreign base company income of a controlled foreign corporation that is attributable to such tax-exempt interest shall be treated as tax-exempt interest in the hands of the U.S. shareholders of the foreign corporation. Accordingly, any net foreign base company income that is included in the subpart F income of a U.S. shareholder and that is attributable to such tax-exempt interest shall remain exempt from the regular income tax, but potentially subject to the alternative minimum tax, in the hands of the U.S. shareholder.

(c) *Excluded rents*—(1) *Trade or business cases.* Rents will be considered for purposes of paragraph (b)(5) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (''lessor'') from leasing—

(i) Property which the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind,

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased,

(iii) Personal property ordinarily used by the lessor in the active conduct

of a trade or business, leased during a temporary period when the property would, but for such leasing, be idle, or

(iv) Property which is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and which is substantial in relation to the amount of rents derived from the leasing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* An organization in a foreign country will be considered substantial in relation to the amount of rents, for purposes of paragraph (c)(1)(iv) of this section, if active leasing expenses, as defined in paragraph (c)(2)(iii), equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses* The term ''active leasing expenses'' means the deductions incurred by an organization of the lessor in a foreign country which are properly allocable to rental income and which would be allowable under section 162 to the lessor (were the lessor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the lessor,

(B) Deductions for rents paid or accrued,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the lessor (were the lessor a domestic corporation) under sections other than section 162 (such as sections 167 and 168), and

(D) Deductions for payments made to independent contractors with respect to the leased property.

(iv) *Adjusted leasing profit.* The term ''adjusted leasing profit'' means the gross income of the lessor from rents, reduced by the sum of—

(A) The rents paid or incurred by the controlled foreign corporation with respect to such gross rental income,

(B) The amounts which would be allowable to such lessor (were the lessor a domestic corporation) as deductions under section 167 or 168 with respect to such rental income, and

(C) The amounts paid to independent contractors with respect to such rental income.

(3) *Illustrations.* The application of this paragraph (c) is illustrated by the following examples.

Example 1. Controlled foreign corporation *A* is regularly engaged in the production of office machines which it sells or leases to others and services. Under paragraph (c)(1)(i) of this section, the rental income of *A* Corporation from the leases is derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 2. Controlled foreign corporation *D* purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, Corporation *D* owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation *D* also leases in country X on a long-term basis, generally for a term of one year, motor vehicles which it owns. Under the terms of the long-term leases, Corporation *D* is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, Corporation *D* maintains and operates an organization therein which is regularly engaged in the business of marketing and servicing the motor vehicles which are leased. The deductions incurred by such organization satisfy the 25-percent test of paragraph (c)(2)(ii) of this section; thus, such organization is substantial in relation to the rents Corporation *D* receives from leasing the motor vehicles. Therefore, under paragraph (c)(1)(iv) of this section, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation *E* owns a complex of apartment buildings which it has acquired by purchase. Corporation *E* engages a real estate management

firm to lease the apartments, manage the buildings and pay over the net rents to the owner. The rental income of *E* Corporation from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. Controlled foreign corporation *F* acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation *F* acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by Corporation *F* from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 6. Controlled foreign corporation *G* owns equipment which it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, Corporation *G* continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Trade or business cases.* Royalties will be considered for purposes of paragarph (b)(5) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (''licensor'') from licensing— (i) Property which the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind, or

(ii) Property which is licensed as a result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (d)(1)(i), the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* An organization in a foreign country will be considered substantial in relation to the amount of royalties, for purposes of paragraph (d)(1)(ii) of this section, if the active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses.* The term ''active licensing expenses'' means the deductions incurred by an organization of the licensor which are properly allocable to royalty income and which would be allowable under section 162 to the licensor (were the licensor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the licensor,

(B) Deductions for royalties paid or incurred,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the licensor (were the controlled foreign corporation a domestic corporation) under sections other than section 162 (such as section 167), and

(D) Deductions for payments made to independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term ''adjusted licensing profit'' means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the controlled foreign corporation with respect to such gross royalty income,

(B) The amounts which would be allowable to such licensor as deductions under section 167 (were the licensor a domestic corporation) with respect to such royalty income, and

(C) The amounts paid to independent contractors with respect to such royalty income.

(3) *Illustrations.* The application of this paragraph (d) is illustrated by the following examples.

Example 1. Controlled foreign corporation *A*, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility employees of Corporation A who are full time scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, which ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *A* for the privilege of using patented rights which it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 2. Assume that Corporation *A* in example 1, in addition to receiving royalties for the use of patents which it develops, receives royalties for the use of patents which it acquires by purchase and licenses to others without adding any value thereto. Corporation *A* generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation *A*, that Corporation *A* has acquired rights under a patent and is interested in licensing its rights. Corporation *A* does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation *A* for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 3. Controlled foreign corporation *B* receives royalties for the use of patents which it acquires by purchase. The primary business of Corporation *B*, operated on a regular basis, consists of licensing patents which it has purchased ''raw'' from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation *B*, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *B* from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation *D* finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation *D* also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice which is intended to promote the use of the patented property. Corporation *D* does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the patents. Royalties received by Corporation *D* for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions*—(1) *In general*—(i) *Inclusion in FPHC income.* Foreign personal holding company income includes the excess of gains over losses from the sale or exchange of—

(A) Property which gives rise to dividends, interest, rents, royalties or annuities as described in paragraph (e)(2) of this section, and

(B) Property which does not give rise to income, as described in paragraph (e)(3) of this section.

If losses from the sale or exchange of such property exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (e), and may not be allocated to, or otherwise reduce, other foreign personal holding company income under section 954(b)(5) and § 1.954–1T(c). Gain or loss from a transaction that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss as defined in paragraph (g), but is gain or loss from the sale or exchange of property which is included in the computation of foreign personal holding company income under this paragraph (e)(1). Paragraphs (e) (4) and (5) of this section provide specific rules for determining whether gain or loss from dispositions of debt instruments and dispositions of options or similar property must be included in the computation of foreign personal holding company income under this paragraph (e)(1). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company

income under any provision of this paragraph (e).

(ii) *Dual character property.* Property may only in part constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or property that does not give rise to any income as described in paragraph (e)(3) of this section. In such cases, the property must be treated as two separate properties for purposes of this paragraph (e). Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under this paragraph (e), and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated for purposes of this paragraph (e)(1)(i) pursuant to the method that most reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain which is included in the computation of foreign personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(ii) addresses the contemporaneous use of property for dual purposes; for rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income*—(i) *In general.* Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (b) of this section, except for rents and royalties derived from unrelated persons in the active conduct of a trade or business under paragraph (b)(5) of this section. The property described by this paragraph (e)(2) includes property which gives rise to export financing interest described in paragraph (b)(2) of this section and property which gives rise to income from related persons described in paragraphs (b)(3) and (b)(4) of this section.

(ii) *Exception.* Property described in this paragraph (e)(2) does not include—

(A) Dealer property (as defined in paragraph (a)(4)(iv) of this section), and

(B) Inventory and similar property (as defined in paragraph (a)(4)(ii) of this section) other than securities.

(3) *Property that does not give rise to income.* The term ''property that does not give rise to income'' for purposes of this section includes all rights and interests in property (whether or not a capital asset) except—

(i) Property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (e)(2) of this section and property that gives rise to rents and royalties derived in the active conduct of a trade or business under paragraph (b)(5) of this section;

(ii) Dealer property (as defined in paragraph (a)(4)(iv) of this section);

(iii) Inventory and similar property (as defined in paragraph (a)(4)(ii)) other than securities;

(iv) Property (other than real property) used in the controlled foreign corporation's trade or business that is of a character which would be subject to the allowance for depreciation under section 167 or 168 and the regulations thereunder (including tangible property described in § 1.167(a)–2 and intangibles described in § 1.167(a)–3);

(v) Real property that does not give rise to rental or similar income, to the extent used in the controlled foreign corporation's trade or business; and

(vi) Intangible property as defined in section 936(h)(3)(B) and goodwill that is not subject to the allowance for depreciation under section 167 and the regulations thereunder to the extent used in the controlled foreign corporation's trade or business and disposed of in connection with the sale of a trade or business of the controlled foreign corporation.

(4) *Classification of gain or loss from the disposition of a debt instrument or on a deferred payment sale*—(i) *Gain.* Gain from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is treated as interest income (as defined in paragraph (a)(4)(i) of this section); or

(B) It is treated as income equivalent to interest under paragraph (h) of this section.

(ii) *Loss.* Loss from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is directly allocated to interest income (as defined in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Code or regulations thereunder;

(B) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Code or regulations thereunder; or

(C) The debt instrument was taken in consideration for the sale or exchange of property (or the provision of services) by the controlled foreign corporation and gain or loss from that sale or exchange (or income from the provision of services) is not includible in foreign base company income under this section.

(5) *Classification of options and other rights to acquire or transfer property.* Subject to the exceptions provided in paragraphs (e)(3) (ii) and (iii) of this section (relating to certain dealer property and inventory property), rights to acquire or transfer property, including property that gives rise to income, are classified as property that does not give rise to income under paragraph (e)(3) of this section. These rights include options, warrants, futures contracts, options on a futures contract, forward contracts, and options on an index relating to stocks, securities or interest rates.

(6) *Classification of certain interests in pass through entities.* [Reserved.]

(f) *Commodities transactions*—(1) *In general.* Except as otherwise provided in this paragraph (f), foreign personal holding company income includes the excess of gains over losses from commodities transactions. If losses from commodities transactions exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (f), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954–1T(a)(4). The terms ''commodity'' and ''commodities transactions'' are defined in paragraph (f)(2) of this section. Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f). The term ''qualified active sales'' is defined in paragraph (f)(3). The term ''qualified hedging transaction'' is defined in paragraph (f)(4) of this section. An election is provided under paragraph (g)(5) of this section to include all gains and losses from section 1256 foreign currency transactions, which would otherwise be commodities transactions, in the computation of foreign personal holding company income under paragraph (g) instead of this paragraph (f). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (f).

(2) *Definitions*—(i) *Commodity.* For purposes of this section, the term ''commodity'' means:

(A) Tangible personal property of a kind which is actively traded or with respect to which contractual interests are actively traded, and

(B) Nonfunctional currency (as defined under section 988 and the regulations thereunder).

(ii) *Commodities transaction.* A commodities transaction means the purchase or sale of a commodity for immediate (spot) delivery, or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity, accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to:

(A) A futures or forward contract in a commodity,

(B) A leverage contract in a commodity purchased from leverage transaction merchants,

(C) An exchange of futures for physical transaction,

(D) A transaction in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities,

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities, and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(3) *Definition of the term ''qualified active sales''*—(i) *In general.* The term ''qualified active sales'' means the sale of commodities in the active conduct of a commodity business as a producer, processor, merchant, or handler of commodities if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities of like kind. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities of like kind is not a qualified active sale.

(ii) *Sale of commodities.* The term ''sale of commodities'' means any transaction in which the controlled foreign corporation intends to deliver to a purchaser a commodity held by the controlled foreign corporation in physical form.

(iii) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only if—

(A) It holds commodities as inventory or similar property (as defined in paragraph (a)(4)(ii)); and

(B) It incurs substantial expenses in the ordinary course of a commodities business from engaging in one of the following activities directly, and not through an independent contractor:

(*1*) Substantial activities in the production of commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals.

(*2*) Substantial processing activities prior to the sale of commodities including concentrating, refining, mixing, crushing, aerating, or milling; or

(*3*) Significant activities relating to the physical movement, handling and storage of commodities including preparation of contracts and invoices; arranging freight, insurance and credit; arranging for receipt, transfer or negotiation of shipping documents; arranging storage or warehousing, and dealing with quality claims; owning and operating facilities for storage or warehousing or owning or chartering vessels or vehicles for the transportation of commodities.

For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant, or handler of commodities if its business is primarily financial. In general, the business of a controlled foreign corporation is financial if it primarily engages in commodities transactions for investment or speculation, or if it primarily provides products or services to customers for investment or speculation.

(iv) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities if the activities described in paragraph (f)(3)(iii) give rise to 85 percent of the taxable income of the controlled foreign corporation (computed

as though the corporation were a domestic corporation). For this purpose, gains or losses from qualified hedging transactions, as defined in paragraph (f)(4), are considered derived from the qualified active sales to which they relate or are expected to relate.

(4) *Definition of the term ''qualified hedging transaction.''* The term ''qualified hedging transaction'' means a bona fide hedging transaction that:

(i) Is reasonably necessary to the conduct of business as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others;

(ii) Is entered into primarily to reduce the risk of price change (but not the risk of currency fluctuations) with respect to commodities sold or to be sold in qualified active sales described in paragraph (f)(3) of this paragraph; and

(iii) Is clearly identified on the controlled foreign corporation's records before the close of the fifth day after the day during which the hedging transaction is entered into and at a time when there is a reasonable risk of loss; however, if the controlled foreign corporation does not at such time specifically and properly identify the qualified active sales (or category of such sales) to which a hedging transaction relates, the district director in his sole discretion may determine which hedging transactions (if any) are related to qualified active sales.

(g) *Foreign currency gain*—(1) *In general.* Except as provided in paragraph (g)(2), foreign personal holding company income includes the excess of foreign currency gains over losses (as defined in section 988(b)) attributable to any section 988 transactions. If foreign currency losses exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (g), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954–1T(a)(4). To the extent the gain or loss from a transaction is treated as interest income or expense under sections 988(a)(2) or 988(d) and the regulations thereunder, it is not included in the computation of foreign personal holding company income under this paragraph (g). (For other rules concerning income described in more than one category of foreign personal holding company income, see § 1.954–2(a)(2).) A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (g).

(2) *Exceptions*—(i) *Qualified business units using the dollar approximate separate transactions method.* Any DASTM gain or loss computed under § 1.985–3(d) must be allocated under the rules of § 1.985–3 (e)(2)(iv) or (e)(3).

(ii) *Tracing to exclude foreign currency gain or loss from qualified business and hedging transactions.* A foreign currency gain or loss is excluded from the computation of foreign personal holding company income under this paragraph (g) if it is clearly identified on the records of the controlled foreign corporation as being derived from a qualified business transaction or a qualified hedging transaction. The term ''qualified business transaction'' is defined in paragraph (g)(3) of this section. The term ''qualified hedging transaction'' is defined paragraph (g)(4) of this section. However, currency gain or loss of a qualified business unit included in the computation of currency gain or loss under subdivision (i) of this paragraph (g)(2) may not be excluded from foreign personal holding company income under the tracing rule of this paragraph (g)(2)(ii). Furthermore, the tracing rule of this paragraph (g)(2)(ii) will not apply if a controlled foreign corporation makes the election provided by paragraph (g)(2)(iii) of this section.

(iii) *Election out of tracing.* A controlled foreign corporation may elect a method of accounting under which all foreign currency gains or losses attributable to section 988 transactions are included in foreign personal holding company income. The scope and requirements for this election are provided in paragraph (g)(5) of this section. This election does not apply to foreign currency gains or losses of a qualified business unit included in the

computation of gain or loss under paragraph (g)(2)(i) of this section.

(3) *Definition of the term ''qualified business transaction''*—(i) *In general.* The term ''qualified business transaction'' means a transaction (other than a ''qualified hedging transaction'' as described in paragraph (g)(4) of this section) that:

(A) Does not have investment or speculation as a significant purpose;

(B) Is not attributable to property or an activity of the kind that gives rise to subpart F income (other than foreign currency gain under this paragraph (g)), or could reasonably be expected to give rise to subpart F income (including upon disposition); for example, the transaction may not be attributable to stock or debt of another corporation (including related corporations organized and operating in the same country), or property likely to give rise to foreign base company sales or services income; and

(C) Is attributable to business transactions described in subdivision (ii) of this paragraph (g)(3).

A qualified business transaction includes the disposition of a debt instrument that constitutes inventory property under paragraph (a)(4)(ii) or dealer property under paragraph (a)(4)(iv) of this section. The provisions of this paragraph (g)(3) do not apply to the foreign currency gain or loss of a qualified business unit (as determined under § 1.985–3T(d)(2)) included in the computation of gain or loss under paragraph (g)(2)(i) of this section. The provisions of this paragraph (g)(3) do, however, apply to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985–2T. Qualified business transactions and the amount of foreign currency gain or loss derived therefrom must be clearly identified on its records by the controlled foreign corporation. If the controlled foreign corporation is unable to specifically identify the qualified business transactions and the foreign currency gain or loss derived therefrom, the district director in his sole discretion may determine which transactions of the corporation giving rise to the foreign currency gains or losses are attributable to qualified business transactions.

(ii) *Specific business transactions.* A transaction of a controlled foreign corporation must meet the requirements of any of subdivisions (A) through (F) of this paragraph (g)(3)(ii) to be a qualified business transaction under this paragraph (g)(3).

(A) *Acquisition of debt instruments.* If the transaction is the acquisition of a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be derived from—

(*1*) The sale of inventory and similar property to customers by the controlled foreign corporation in the ordinary course of regular business operations, or

(*2*) The rendition of services by the corporation in the ordinary course of regular business operations.

For purposes of this paragraph (g)(3)(ii)(A), a debt instrument will not be considered derived in the ordinary course of regular business operations unless the instrument matures, and is reasonably expected to be satisfied, within the period for which interest need not be charged under section 482 and the regulations thereunder.

(B) *Becoming the obligor under debt instruments.* If the transaction is becoming the obligor under a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be incurred for:

(*1*) Payment of expenses that are includible by the controlled foreign corporation in the cost of goods sold under § 1.61–3 for property held primarily for sale to customers in the ordinary course of regular business operations, are inventoriable costs under section 471 and the regulations thereunder, or are allocable or apportionable under the rules of § 1.861–8 to gross income derived from inventory and similar property,

(*2*) Payment of expenses that are allocable or apportionable under the rules of § 1.861–8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations,

(*3*) Acquisition of an asset that does not give rise to subpart F income during the current taxable year (other than by application of section 952(c)) and is not reasonably expected to give rise to subpart F income in subsequent taxable years, or

(*4*) Acquisition of dealer property as defined in paragraph (a)(4)(iv) of this section.

The identification requirements of subdivision (i) of this paragraph (g)(3) will not be met with respect to a borrowing if the controlled foreign corporation fails to clearly identify the debt and the expenses (or categories of expenses) to which it relates before the close of the fifth day after the day on which the expenses are incurred.

(C) *Accrual of any item of gross income.* If the transaction is the accrual (or otherwise taking into account) of any item of gross income or receipts as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of gross income or receipts must be derived from:

(*1*) The sale of inventory and similar property in the ordinary course of regular business operations, or

(*2*) The provision of services by the controlled foreign corporation to customers in the ordinary course of regular business operations.

(D) *Accrual of any item of expense.* If the transaction is the accrual (or otherwise taking into account) of any item of expense as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of expense must be:

(*1*) An expense that is includible by the controlled foreign corporation in the cost of goods sold under § 1.61–3 for property held primarily for sale to customers in the ordinary course of regular business operations, is an inventoriable cost under section 471 and the regulations thereunder, or is allocable or apportionable under the rules of § 1.861–8 to gross income derived from inventory and similar property, or

(*2*) An expense that is allocable or apportionable under the rules of § 1.861–8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations.

(E) *Entering into forward contracts, futures contracts, options and similar instruments.* If the transaction is entering into any forward contract, futures contract, option or similar financial instrument and if such contract or instrument is not marked to market at the close of the taxable year under section 1256, as described in section 988(c)(1)(B)(iii) and the regulations thereunder, then the contract or instrument must be property held as dealer property as defined in paragraph (a)(4)(ii) of this section.

(F) *Disposition of nonfunctional currency.* If the transaction is the disposition of nonfunctional currency, as described in section 988(c)(1)(C) and the regulations thereunder, then the transaction must be for a purpose described in paragraph (g)(3)(ii)(B), for the payment of taxes not attributable to subpart F income, or must be the disposition of property held as dealer property as defined in paragraph (a)(4)(iv) of this section.

(G) *Transactions in business assets.* The acquisition or disposition of an asset that is used or held for use in the active conduct of a trade or business.

(4) *Definition of the term ''qualified hedging transaction''*—(i) *In general.* The term ''qualified hedging transaction'' means a bona fide hedging transaction meeting all the requirements of subdivisions (A) through (D) of this paragraph (g)(4)(i):

(A) The transaction must be reasonably necessary to the conduct of regular business operations in the manner in which such business operations are customarily and usually conducted by others.

(B) The transaction must be entered into primarily to reduce the risk of currency fluctuations with respect to property or services sold or to be sold or expenses incurred or to be incurred in transactions that are qualified business transactions under paragraph (g)(3) of this section.

(C) The hedging transaction and the property or expense (or category of property or expense) to which it relates must be clearly identified on the records of the controlled foreign corporation before the close of the fifth day after the day during which the hedging transaction is entered into and

at a time during which there is a reasonable risk of currency loss.

(D) The amount of foreign currency gain or loss that is attributable to a specific hedging transaction must be clearly identifiable on the records of the controlled foreign corporation or its controlling shareholder (as defined in § 1.964–1(c)(5)).

The provisions of this paragraph (g)(4) do not apply to transactions of a qualified business unit included in the computation of gain or loss under paragraph (g)(2)(i). The provisions of this paragraph (g)(4) do apply, however, to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985–3T. If the controlled foreign corporation does not specifically identify the qualified business transactions (or category of qualified business transactions) to which a hedging transaction relates or is unable to specifically identify the amount of foreign currency gain or loss derived from the hedging transactions, the district director in his sole discretion may make the identifications required of the controlled foreign corporation and determine which hedging transactions (if any) are related to qualified business transactions, and the amount of foreign currency gain or loss attributable to the qualified hedging transactions.

(ii) *Change in purpose of hedging transaction.* If a hedging transaction is entered into for one purpose, and the purpose for that transaction subsequently changes, the transaction may be treated as two separate hedging transactions for purposes of this paragraph (g)(4). In such a case, the portion of the transaction that relates to a qualified business transaction is considered a qualified hedging transaction if it separately meets all the other requirements of this paragraph (g)(4) for treatment as a qualified hedging transaction. For purposes of paragraph (g)(4)(i)(C), the foreign corporation must identify on its records the portion of the transaction that relates to a qualified business transaction by the close of the fifth day after the day on which the hedge becomes so related (*i.e.,* either the day on which the hedge is first entered into or on the day on which it first relates to a qualified business transaction due to a change in its purpose). The foreign corporation must identify on its records the portion of the transaction that does not relate to a qualified business transaction by the close of the fifth day after the day on which the purpose for the hedging transaction changes.

(5) *Election out of tracing*—(i) *In general.* A controlled foreign corporation may elect to account for currency gains and losses under section 988 and gains and losses from section 1256 currency contracts by including in the computation of foreign personal holding company income under this paragraph (g) all foreign currency gains or losses attributable to section 988 transactions, and all gains or losses from section 1256 foreign currency contracts. Separate elections for section 1256 foreign currency contracts and section 988 transactions are not permitted. If a controlled foreign corporation makes the election described in this paragraph (g)(5)(i), the election is effective for all related persons as defined in section 954(d)(3) and the regulations thereunder.

(ii) *Exception.* The election provided by this paragraph (g)(5) does not apply to foreign currency gain or loss of a qualified business unit determined under § 1.985–3T(d)(2). It does, however, apply to other foreign currency gains or losses of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency.

(iii) *Procedure*—(A) *In general.* The election provided by this paragraph (g)(5) shall be made in the manner prescribed in this paragraph and in subsequent administrative pronouncements.

(B) *Time and manner.* The controlled foreign corporation may make the election by filing a statement with its original or amended information return for the taxable year for which the election is made. The controlling United States shareholders, as defined in § 1.964–1(c)(5), may make the election on behalf of the controlled foreign corporation and related corporations by filing a statement to such effect with their original or amended income tax returns for the taxable year during

which the taxable year of the controlled foreign corporation for which the election is made ends. The election is effective for the taxable year of the controlled foreign corporation for which the election is made, for the taxable years of all related controlled foreign corporations ending within such taxable year, and for all subsequent years of such corporations. The statement shall include the following information:

(*1*) The name, address, taxpayer identification number, and taxable year of each United States shareholder;

(*2*) The name, address, and taxable year of each controlled foreign corporation for which the election is effective; and

(*3*) Any additional information to be required by the Secretary by administrative pronouncement.

Each United States shareholder or controlled foreign corporation filing the election must provide copies of the election to all controlled foreign corporations for which the election is effective, and all United States shareholders of such corporations. However, failure to provide such copies will not void (or cause to be voidable) an election under this paragraph (g)(5).

(C) *Termination.* The election provided by this paragraph (g)(5) may be terminated only with the consent of the Commissioner: Attn.: CC:INTL.

(h) *Income equivalent to interest*—(1) *In general.* Foreign personal holding company income includes income that is equivalent to interest. Income equivalent to interest includes, but is not limited to, income derived from the following categories of transactions:

(i) An investment, or series of integrated transactions which include an investment, in which the payments, net payments, cash flows, or return predominantly reflect the time value of money, and

(ii) Transactions in which the payments or a predominant portion thereof are in substance for the use or forebearance of money, but are not generally treated as interest.

However, amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest under this paragraph (h). Income from the sale of property will not be treated as income equivalent to interest for purposes of this paragraph (h), subject to the rule of paragraph (h)(4) of this section, unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. See sections 482, 483 and 1274 for the extent to which such income may be characterized as interest income subject to paragraph (b) of this section. Income equivalent to interest for purposes of this paragraph (h) includes all income attributable to a transfer of securities subject to section 1058. Income equivalent to interest also includes a portion of certain deferred payments received for the purpose of services, in accordance with the provisions of paragraph (h)(5) of this section. Income equivalent to interest does not include income attributable to notional principal contracts such as interest rate swaps, currency swaps, interest rate floor agreements, or similar contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest. Income derived from notional contracts by a person acting in its capacity as a regular dealer in such contracts will be presumed not to be integrated with an investment.

(2) *Illustrations.* The following examples illustrate the application of this paragraph (h):

Example 1. CFC, a controlled foreign corporation, promises that *A,* an unrelated person, may borrow up to $500 in principal for one year beginning at any time during the next three months at an interest rate of 10 percent. In exchange, *A* pays *CFC* a commitment fee of $2.00. Pursuant to this loan commitment, *CFC* lends $80 to *A*. As a result, the entire $2.00 fee is included in the computation of foreign personal holding company income under this paragraph (h)(1)(ii).

Example 2. (i) At the beginning of its current taxable year, *CFC,* a controlled foreign corporation, purchases at face value a one-year debt instrument issued by *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (''LIBOR'') plus one percentage point. Contemporaneously, *CFC* borrows $100 from *B* for one year at a fixed interest rate of 10 percent, using the debt instrument as security.

(ii) During its current taxable year, *CFC* accrues $11 of interest from *A* on the bond. That interest is foreign personal holding company income under section 954(c)(1) and

§ 1.954–2T(b), and thus is not income equivalent to interest. During its current taxable year, *CFC* incurs $10 of interest expense with respect to the borrowing from *B*. That expense is allocated and apportioned to, and reduces, foreign base company income or insurance income to the extent provided in sections 954(b)(5), 863(e), and 864(e) and the regulations thereunder.

Example 3. (i) At the beginning of its 1988 taxable year, *CFC*, a controlled foreign corporation, purchases at face value a one-year debt instrument issued by *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (''LIBOR'') plus one percentage point payable on the last day of *CFC*'s current taxable year. *CFC* subsequently determines that it would prefer receiving interest at a fixed rate, and, on January 1, 1989, enters into an agreement with *B*, an unrelated person, whereby *B* promises to pay *CFC* on the last day of *CFC*'s 1989 taxable year an amount equal to 10 percent on a notional principal amount of $100. In exchange, *CFC* promises to pay *B* on the last day of *CFC*'s 1989 taxable year an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) *CFC* receives a total of $10 from *B*, and pays $9 to *B*. *CFC* also receives $9 from *A*. The $9 paid to *B* is directly allocated to, or is otherwise an adjustment to, the $10 received from *B*. The transactions are considered an intergrated transaction giving rise to $9 of interest income (paid by *A*) and, under paragraph (h)(1)(i), $1 of income equivalent to interest (paid by *B*).

Example 4. The facts are the same as in Example 3, except that *CFC* does not hold any debt obligations. Since the transaction with *B* is not integrated with an investment giving rise to interest or income equivalent to interest, the net $1 of income realized by *CFC* does not constitute income equivalent to interest.

Example 5. (i) *CFC*, a controlled foreign corporation, enters into an agreement with *A* whereby *CFC* purchases commodity X from *A* at a price of $100, and *A* contemporaneously repurchases commodity X from *CFC* for payment and delivery in 3 months at a price of $104 set by the forward market.

(ii) The transaction is in substance a loan from *CFC* to *A* secured by commodity X. Thus, *CFC* accrues $4 of gross income which is included in foreign personal holding company income as interest under section 954(c)(1)(A) and paragraph (b) of this section.

Example 6. (i) *CFC* purchases commodity Y on the spot market for $100 and contemporaneously, sells commodity Y forward for delivery and payment in 3 months at a price of $104 set by the forward market.

(ii) The $100 paid on the spot purchase of commodity Y offsets any market risk on the forward sale so that the $4 of income to be derived predominantly reflects time value of money. Thus, under paragraph (h)(1)(i), the spot purchase of commodity Y and the offsetting forward sale will be treated as an integrated transaction giving rise to $4 of income equivalent to interest.

(3) *Income equivalent to interest from factoring*—(i) *General rule.* Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(3)(ii) of this section, the term ''factoring income'' includes any income (including any discount income or service fee, but excluding any stated interest) derived from the acquisition and collection or disposition of a factored receivable. The rules of this paragraph (h)(3) apply only with respect to the tax treatment of factoring income derived from the acquisition and collection or disposition of a factored receivable and shall not affect the characterization of an expense or loss of either the person whose goods or services gave rise to a factored receivable or the obligor under a receivable. The amount of income equivalent to interest realized with respect to a factored receivable is the difference (if a positive number) between the amount paid for the receivable by the foreign corporation and the amount that it collects on the receivable (or realizes upon its sale of the receivable).

(ii) *Exceptions.* Factoring income shall not include—

(A) Income treated as interest under section 864(d)(1) or (6) and the regulations thereunder (relating to income derived from trade or service receivables of related persons), even if such income is not treated as described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7);

(B) Income derived from a factored receivable if payment for the acquisition of the receivable is made on or after the date on which stated interest begins to accrue, but only if the rate of stated interest equals or exceeds 120 percent of the Federal short term rate (as defined under section 1274) (or the equivalent rate for a currency other than the dollar) as of the date on which the receivable is acquired by the foreign corporation; or

(C) Income derived from a factored receivable if payment for the acquisition of the receivable by the foreign

corporation is made only on or after the anticipated date of payment of all principal by the obligor (or the anticipated weighted average date of payment of a pool of purchased receivables).

(iii) *Factored receivable.* For purposes of this paragraph (h)(3), the term ''factored receivable'' includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. For purposes of this paragraph (h)(3), it is immaterial whether the person providing the property or services agrees to transfer the receivable at the time of sale (as by accepting a third-party charge or credit card) or at a later time.

(iv) *Illustrations.* The following examples illustrate the application of this paragraph (h)(3).

Example 1. DP, a domestic corporation, owns all of the outstanding stock of FS, a controlled foreign corporation. FS acquires accounts receivable arising from the sale of property by unrelated corporation X. The receivables have a face amount of $100, and after 30 days bear stated interest equal to at least 120 percent of the applicable short term Federal rate (determined as of the date the receivable is acquired). FS purchases the receivables from X for $95 on Day 1 and collects $100 from the obligor under the receivable on Day 40. Income (other than stated interest) derived by FS from the factored receivables is factoring income within the meaning or paragraph (h)(3)(i) of this section and, therefore, is income equivalent to interest.

Example 2. The facts are the same as in example 1, except that FS does not pay X for the receivables until Day 30. Income derived by FS from the factored receivables is not factoring income by reason of paragraph (h)(3)(ii)(B) of this section.

Example 3. The facts are the same as in example 2, except that it is anticipated that all principal will be paid by the obligor of the receivables by Day 30. Income derived by FS from this ''maturity factoring'' of the receivables is not factoring income by reason of paragraph (h)(3)(ii)(C) of this section, and therefore does not give rise to income equivalent to interest.

Example 4. The facts are the same as in example 1, except that, rather than collecting $100 from the obligor under the factored receivable on Day 40, FS sells the receivable to controlled foreign corporation Y on Day 15 for $97. Both the income derived by FS on the factored receivable and the income derived by Y (other than stated interest) on the receivable are factoring income within the meaning of paragraph (h)(3)(i) of this section, and therefore, constitute income equivalent to interest.

Example 5. The facts are the same as in example 4, except that FS sells the factored receivable to Y for $99 on Day 45, at which time interest is accruing on the unpaid balance of $100. FS has $4 of net factoring income that is income equivalent to interest. Because interest was accruing at the time Y acquired the receivable at a rate equal to at least 120 percent of the applicable short term Federal rate, income derived by Y from the factored receivable is not factoring income by reason of pargraph (h)(3)(ii)(B).

Example 6. DP, a domestic corporation engaged in an integrated credit card business, owns all of the outstanding stock of FS, a controlled foreign corporation. On Day 1 individual A uses a credit card issued by DP to purchase shoes priced at $100 from X, a foreign corporation unrelated to DP, FS, or A. By prearrangement with DP, on Day 7, X transfers the receivable arising from A's purchase to FS in exchange for $95. FS collects $100 from A on Day 45. Income derived by FS on the factored receivable is factoring income within the meaning of paragraph (h)(3)(i) of this section and, therefore, is income equivalent to interest.

(4) *Determination of sales income.* Income equivalent to interest for purposes of this paragraph (h) does not include income from the sale of property unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. Income derived by a controlled foreign corporation will be treated as arising from the sale of property only if the corporation in substance carries out sales activities. Accordingly, an arrangement that is designed to lend the form of a sales transaction to a transaction that in substance constitutes and advance of funds will be disregarded. For example, if a controlled foreign corporation acquires property on 30-day payment terms from one person and sells that property to another person on 90 day payment terms and at prearranged prices and terms such that

the foreign corporation bears no substantial economic risk with respect to the purchase and sale other than the risk of non-payment, the foreign corporation has not in substance derived income from the sale of property.

(5) *Receivables arising from performance of services.* If payment for services performed by a controlled foreign corporation is not made until more than 120 days after the date on which such services are performed, then the income derived by the foreign corporation constitutes income equivalent to interest to the extent that interest income would be imputed under the principles of section 483 or the original issue discount provisions (section 1271 *et seq.*), if—

(A) Such provisions applied to contracts for the performance of services,

(B) The time period referred to in sections 483(c)(1) and 1274(c)(1)(B) were 120 days rather than six months, and

(C) The time period referred to in section 483(c)(1)(A) were 120 days rather than one year.

[T.D. 8216, 53 FR 27498, July 21, 1988; 53 FR 29801, Aug. 8, 1988, as amended by T.D. 8556, 59 FR 37672, July 25, 1994. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

PART 5—TEMPORARY INCOME TAX REGULATIONS UNDER THE REVENUE ACT OF 1978

Sec.

5.856–1 Extensions of the grace period for foreclosure property by a real estate investment trust.
5.1502–45 Limitation on losses to amount at risk.
5.1561–1 Taxable years of component members of controlled group of corporations that include December 31, 1978.
5.6411–1 Tentative refund under claim of right adjustment.

AUTHORITY: 26 U.S.C. 7805.

§ 5.856–1 Extensions of the grace period for foreclosure property by a real estate investment trust.

(a) *In general.* Under section 856(e), a real estate investment trust (''REIT'') may elect to treat as foreclosure property certain real property (including interests in real property), and any personal property incident to such real property, that the REIT acquires after December 31, 1973. In general, the REIT must acquire the property as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property (where the REIT was the lessor) or on an indebtedness owed to the REIT which such property secured. Property that a REIT elects to treat as foreclosure property ceases to be foreclosure property with respect to such REIT at the end of a grace period. The grace period ends on the date which is 2 years after the date on which the REIT acquired the property, unless the REIT has been granted an extension or extensions of the grace period. If the grace period is extended, the property ceases to be foreclosure property on the day immediately following the last day of the grace period, as extended.

(b) *Rules for extensions of the grace period.* In general, § 1.856–6(g) prescribes rules regarding extensions of the grace period. However, in order to reflect the amendment of section 856(e)(3) of the Code by section 363(c) of the Revenue Act of 1978, the following rules also apply:

(1) In the case of extensions granted after November 6, 1978, with respect to extension periods beginning after December 31, 1977, the district director may grant one or more extensions of the grace period for the property, subject to the limitation that no extension shall extend the grace period beyond the date which is 6 years after the date the REIT acquired the property. In any other case, an extension shall be for a period of not more than 1 year, and not more than two extensions can be granted with respect to the property.

(2) In the case of an extension period beginning after December 31, 1977, a request for an extension filed on or before March 28, 1980, will be considered to be timely if the limitation on the number and length of extensions in section 856(e)(3), as in effect before the amendment made by section 363(c) of the Revenue Act of 1978, would have barred the extension.

[T.D. 7767, 46 FR 11284, Feb. 6, 1981]

§5.1502–45 Limitation on losses to amount at risk.

(a) *In general*—(1) *Scope.* This section applies to a loss of any subsidiary if the common parent's stock meets the stock ownership requirement described in section 465(a)(1)(C).

(2) *Limitation on use of losses.* Except as provided in paragraph (a)(4) of this section, a loss from an activity of a subsidiary during a consolidated return year is includible in the computation of consolidated taxable income (or consolidated net operating loss) and consolidated capital gain net income (or consolidated net capital loss) only to the extent the loss does not exceed the amount that the parent is at risk in the activity at the close of that subsidiary's taxable year. In addition, the sum of a subsidiary's losses from all its activities is includible only to the extent that the parent is at risk in the subsidiary at the close of that year. Any excess may not be taken into account for the consolidated return year but will be treated as a deduction allocable to that activity of the subsidiary in the first succeeding taxable year.

(3) *Amount parent is at risk in subsidiary's activity.* The amount the parent is at risk in an activity of a subsidiary is the lesser of (i) the amount the parent is at risk in the subsidiary or (ii) the amount the subsidiary is at risk in the activity. These amounts are determined under paragraph (b) of this section and the principles of section 465. See section 465 and the regulations thereunder and the examples in paragraph (e) of this section.

(4) *Excluded activities.* The limitation on the use of losses in paragraph (a)(2) of this section does not apply to a loss attributable to an activity described in section 465(c)(3)(D).

(5) *Substance over form.* Any transaction or arrangement between members (or between a member and a person that is not a member) which does not cause the parent to be economically at risk in an activity of a subsidiary will be treated in accordance with the substance of the transaction or arrangement notwithstanding any other provision of this section.

(b) *Rules for determining amount at risk*—(1) *Excluded amounts.* The amount a parent is at risk in an activity of a subsidiary at the close of the subsidiary's taxable year does not include any amount which would not be taken into account under section 465 were the subsidiary not a separate corporation. Thus, for example, if the amount a parent is at risk in the activity of a subsidiary is attributable to nonrecourse financing, the amount at risk is not more than the fair market value of the property (other than the subsidiary's stock or debt or assets) pledged as security.

(2) *Guarantees.* If a parent guarantees a loan by a person other than a member to a subsidiary, the loan increases the amount the parent is at risk in the activity of the subsidiary.

(c) *Application of section 465.* This section applies in a manner consistent with the provisions of section 465. Thus, for example, the recapture of losses provided in section 465(e) applies if the amount the parent is at risk in the activity of a subsidiary is reduced below zero.

(d) *Other consolidated return provisions unaffected.* This section limits only the extent to which losses of a subsidiary may be used in a consolidated return year. This section does not apply for other purposes, such as §§1.1502–32 and 1.1502–19, relating to investment in stock of a subsidiary and excess loss accounts, repectively. Thus, a loss which reduces a subsidiary's earnings and profits in a consolidated return year, but is disallowed as a deduction for the year by reason of this section, may nonetheless result in a negative adjustment to the basis of an owning member's stock in the subsidiary or create (or increase) an excess loss account.

(e) *Examples.* The provisions of this section may be illustrated by the examples in this paragraph (e). In each example, the stock ownership requirement of section 465(a)(1)(C) is met for the stock of the parent (P), and each affiliated group files a consolidated return on a calendar year basis and comprises only the members described.

Example (1). In 1979, P forms S with a contribution of $200 in exchange for all of S's stock. During the year, S borrows $400 from a commercial lender and P guarantees $100 of the loan. S uses $500 of its funds to acquire a motion picture film. S incurs a loss of $120 for the year with respect to the film. At the

close of 1979, the amount P is at risk in S's activity is $300. If S has no gain or loss in 1980, and there are no contributions from or distributions to P, at the close of 1980 P's amount at risk in S's activity will be $180.

Example (2). P forms S–1 with a capital contribution of $1 on January 1, 1980. On February 1, 1980. S–1 borrows $100 with full recourse and contributes all $101 to its newly formed subsidiary S–2. S–2 uses the proceeds to explore for natural oil and gas resources. S–2 incurs neither gain nor loss from its explorations during the taxable year. As of December 31, 1980, P is at risk in the exploration activity of S–2 only to the extent of $1.

(f) *Effective date.* This section applies to consolidated return years ending on or after December 31, 1979.

[T.D. 7685, 45 FR 16484, Mar. 14, 1980]

§ 5.1561–1 Taxable years of component members of controlled group of corporations that include December 31, 1978.

(a) *In general.* This section prescribes a regulation for applying sections 301 (a) and (b) (19), and 106, of the Revenue Act of 1978 (the Act) in the case of certain taxable years of component members of a controlled group of corporations (as defined in section 1563 of the Internal Revenue Code). The section applies only to taxable years that include December 31, 1978, and only if the taxable year of at least one component member ends in 1979.

(b) *Background.* Section 301(a) of the Act amends section 11 of the Code (relating to tax imposed on corporations) to provide for taxable income brackets that are subject to tax at rates less than the maximum rate of 46 percent. Section 301(b)(19) of the Act amends section 1561(a) of the Code (relating to limitations on certain multiple tax benefits in the case of certain controlled corporations) to limit the component members of a controlled group to an aggregate amount in each bracket which does not exceed the maximum amount in such bracket to which a corporation which is not a component member of a controlled group is entitled. Section 106 of the Act amends section 21 of the Code (relating to effect of changes in rate of tax) to provide that the amendments made by section 301 of the Act shall be treated as a change in a rate of tax. Since the amendments made by section 301 of the Act are effective for taxable years beginning after December 31, 1978, under the amendment to section 21 the effective date of the change in rate of tax is January 1, 1979.

(c) *No apportionment plan in effect.* If no apportionment plan (see § 1.1561–3 of the Income Tax Regulations) is in effect with respect to December 31, 1978, the single $50,000 surtax exemption available before January 1, 1979, and the single bracket amounts available after December 31, 1978, shall be equally divided among the component members of the controlled group on December 31, 1978. In the case of a controlled group which includes component members that join in the filing of a consolidated return and other component members that do not join in the filing of such a return, each component member of the group (including each component member that joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the $50,000 surtax exemption in effect before January 1, 1979, and the bracket amounts in effect after December 31, 1978. In such a case, the surtax exemption and bracket amounts of the corporations filing the consolidated return shall be the sum of the amount apportioned to each component member that joins in filing the consolidated return.

(d) *Apportionment plan.* (1) If one or more component members of the controlled group have a calendar taxable year and if an apportionment plan is adopted under § 1.1561–3 apportioning the entire $50,000 surtax exemption available for 1978 to such calendar-year members, then the amount in each taxable income bracket available for fiscal-year members is zero. If only a part of the $50,000 surtax exemption is apportioned to calendar-year members, then a proportionate part of the $25,000 amount in each taxable income bracket is available for the fiscal-year members. For example, if $30,000 (3/5 of $50,000) is apportioned to calendar-year members, 2/5 of the $25,000 amount in each bracket, or $10,000, as well as the remaining 2/5 of the 1978 surtax exemption, is available to the fiscal-year members.

(2) The amount in each taxable income bracket available to fiscal-year

members may be apportioned among such members in any manner the controlled group may select. For example, the available amount in the first bracket (subject to a 17-percent rate) may be allocated to one member, the amount in the second bracket (subject to a 20-percent rate) may be allocated to another member, and so on. Moreover, the available amount in each bracket may be divided among the members in any manner the group may select.

(3) In computing 1978 tentative taxes under section 21, the total surtax exemption available to fiscal-year members for 1978 must be divided among such members in the same proportion as the sum of the available amount in each bracket is divided among them. Thus, if the sum of the available bracket amounts is $100,000 (*i.e.*, $25,000 in each bracket), and if corporation X is apportioned 30 percent, or $30,000, of this amount (regardless of which brackets corporation X may select), then 30 percent of the surtax exemption available to the fiscal-year members for 1978 (*i.e.*, 30 percent of $50,000, or $15,000) must be apportioned to corporation X.

(e) *Corporations affected.* The provisions of section 1561 may reduce the surtax exemption or bracket amounts of any corporation which is a component member of a controlled group of corporations and which is subject to the tax imposed by section 11, or by any other provision of subtitle A of the Code if the tax under such other provisions is computed by reference to the tax imposed by section 11. Such other provisions include, for example, sections 511(a)(1), 594, 802, 831, 852, 857, 882, 1201, and 1378.

(f) *Example.* This section may be illustrated by the following example:

Example. Corporations X, Y, and Z are component members of a controlled group of corporations on December 31, 1978. X has taxable income of $10,000 for the taxable year ending December 31, 1978. Y has taxable income of $60,000 for the taxable year ending June 30, 1979. Z has taxable income of $90,000 for the taxable year ending September 30, 1979. The group files an apportionment plan under § 1.1561–3 apportioning $10,000 (*i.e.*, ⅕ of $50,000) to X, the calendar-year member. Therefore, ⅘ of the amount in each bracket, or $20,000, is available to Y and Z, the fiscal-year members. Under the plan, Y is apportioned the entire amount in the first bracket and $10,000 of the amount in the second bracket. Z is apportioned $10,000 of the amount in the second bracket and the entire amount in the third and fourth brackets. Therefore, Y is apportioned $30,000, or ⅜ of the total available amount in the four brackets, and Z is apportioned $50,000, or ⅝ of the total available amount. The tax liabilities of Y and Z for their taxable years ending in 1979 are computed as follows: (Computation of X's tax liability for 1978, using a surtax exemption of $10,000, is not shown.)

1979 TENTATIVE TAX

	Y
Taxable income	$60,000
Tax on amount in first bracket: 17 percent of $20,000	3,400
Tax on amount in second bracket: 20 percent of $10,000	2,000
Tax on remaining income: 46 percent of $30,000	13,800
1979 tentative tax	19,200

	Z
Taxable income	90,000
Tax on amount in second bracket: 20 percent of $10,000	2,000
Tax on amount in third bracket: 30 percent of $20,000	6,000
Tax on amount in fourth bracket: 40 percent of $20,000	8,000
Tax on remaining income: 46 percent of $40,000	18,400
1979 tentative tax	34,400

1978 TENTATIVE TAX

			Y
Taxable income			60,000
Normal tax:			
20 percent of $7,500 (3/8 of $20,000)			1,500
22 percent of $52,500			11,550
			13,050
Surtax:			
Taxable income	$60,000		
Surtax exemption	15,000	(3/8 of $40,000)	
	$45,000	×26 percent	11,700
1978 tentative tax			24,750
			Z
Taxable income			90,000
Normal tax:			
20 percent of $12,500 (5/8 of $20,000)			2,500
22 percent of $77,500			17,050
			19,500
Surtax:			
Taxable income	$90,000		
Surtax exemption	25,000	(5/8 of $40,000)	
	$65,000	× 26 percent	16,900
1978 tentative tax			36,450
The 1978 and 1979 tentative taxes are apportioned as follows:			
Corporation Y:			
1978—184/365 of $24,750			12,477
1979—181/365 of $19,200			9,521
Total tax for taxable year			21,998
Corporation Z:			
1978—92/365 of $36,450			9,187
1979—273/365 of $34,400			25,729
Total tax for taxable year			34,916

[T.D. 7583, 44 FR 872, Jan. 4, 1979]

§ 5.6411–1 Tentative refund under claim of right adjustment.

(a) *Effective date.* This section applies to applications for tentative refunds filed after November 5, 1978, under section 6411(d).

(b) *In general.* Section 6411(d) allows taxpayers to apply for a tentative refund of amounts treated under section 1341(b)(1) as an overpayment of tax under a claim of right adjustment. This section contains rules for filing an application for this tentative refund. The computation of amounts treated as an overpayment must be made in accordance with section 1341 and the regulations under that section.

(c) *Method of applying for tentative refund*—(1) *In general.* For a corporation, the application is made by filing Form 1139. For taxpayers other than corporations, the application is made by filing Form 1045. The application must be made by filing those forms even if the taxpayer is not applying for a tentative carryback adjustment under section 6411(a). If the taxpayer files the form to apply for the section 6411(d) tentative refund only, it may disregard those lines on the form used to compute the section 6411(a) carryback adjustment. If the taxpayer has a carryback of a net operating loss, credit, or capital loss for the taxable year (determined without the deduction described in

secion 1341(a)(2)) and applies for both the secion 6411(a) tenative carryback adjustment and the section 6411(d) tentative refund, an ordering rule applies. The taxpayer must take into account any adjustments made in applying for the tentative carryback adjustment under section 6411(a) before determining the amount of the overpayment for which an application under section 6411(d) is being made. The taxpayer must attach to the form a separate schedule containing the information required under paragraph (d) of this section.

(2) *Applications made before February 7, 1980.* Applications made before February 7, 1980 that are made under penalties of perjury will be considered meeting the requirements of this section if made by filing a separate statement whether or not it is attached to Form 1139 or 1045. This application, however, must contain the information required under paragraph (d) of this section (other than paragraph (d)(2)).

(d) *Information required*—(1) *In general.* The application must contain (i) the taxpayer's name, address, and identification number and (ii) the information set forth in paragraph (d) (2) and (3) of this section, determined in accordance with section 1341 and the regulations under that section. For example, the decrease in tax under paragraph (d)(3)(iii) of this section is determined under § 1.1341–1(d)(4).

(2) *Computation under section 1341(a)(4).* The application must contain the following information related to the computation under section 1341(a)(4):

(i) The amount of income restored by the taxpayer to another during the taxable year and the amount of the corresponding deduction described in section 1341(a)(2);

(ii) The tax for the taxable year computed with the deduction described in section 1341(a)(2); and

(iii) The tax for each prior taxable year (determined before adjustment under section 1341) to which any net operating loss described in section 1341(b)(4)(A) may be carried and the decrease in tax for each of those years that results from the carryback of that loss.

(3) *Computation under section 1341(a)(5).* The application must contain the following information related to the computation under section 1341(a)(5):

(i) The tax for the taxable year without the deduction described in section 1341(a)(2);

(ii) The tax for each prior taxable year (determined before adjustment under section 1341) for which a decrease in tax is computed under section 1341(a)(5)(B);

(iii) The decrease in tax for each prior taxable year computed under section 1341(a)(5)(B), including any decrease resulting from a net operating loss or capital loss described in section 1341(b)(4)(B); and

(iv) The amount treated as an overpayment of tax under section 1341(b)(1).

(e) *Time and place for filing.* The application must be filed no earlier than the date of filing the return for the taxable year of restoration and no later than the date 12 months from the last day of that taxable year. The application must be filed with the Internal Revenue Service Center (or other office) where the taxpayer filed its return for the taxable year of restoration.

(f) *Not a claim for credit or refund.* An application for tentative refund under section 6411(d) is not a claim for credit or refund. The principles of paragraph (b)(2) of § 1.6411–1 apply in determining the effect of an application for a tentative refund. For example, the filing of an application for tentative refund under section 6411(d) is not a claim for credit or refund in determining whether a claim for credit or refund was timely filed.

[T.D. 7672, 45 FR 8295, Feb. 7, 1980; 45 FR 17138, Mar. 18, 1980]

PART 5c—TEMPORARY INCOME TAX REGULATIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981

Sec.

5c.44F–1 Leases and qualified research expenses.
5c.103–1 Leases and capital expenditures.
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5c.103–3 Leases and arbitrage.
5c.168(f)(8)–1 Special rules for leases.

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5c.168(f)(8)–5 Term of lease.
5c.168(f)(8)–6 Qualified leased property.
5c.168(f)(8)–7 Reporting of income deductions and investment tax credit; at risk rules.
5c.168(f)(8)–8 Loss of section 168(f)(8) protection; recapture.
5c.168(f)(8)–9 Pass-through leases—transfer of only the investment tax credit to a party other than the ultimate user of the property. [Reserved]
5c.168(f)(8)–10 Leases between related parties. [Reserved]
5c.168(f)(8)–11 Consolidated returns. [Reserved]
5c.442–1 Temporary regulations relating to change of annual accounting period.
5c.1305–1 Special income averaging rules for taxpayers otherwise required to compute tax in accordance with § 5c.1256–3.

AUTHORITY: 26 U.S.C. 168(f)(8)(G) and 7805.

SOURCE: T.D. 7791, 46 FR 51907, Oct. 23, 1981, unless otherwise noted.

§ 5c.44F–1 Leases and qualified research expenses.

For purposes of section 44F(b)(2)(A)(iii), the determination of whether any amount is paid or incurred to another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8). See § 5c.168(f)(8)–1(b).

§ 5c.103–1 Leases and capital expenditures.

For purposes of section 103(b)(6)(D) and § 1.103–10(b)(2)(iv)(*b*), the determination of whether property is leased and whether property is of a type that is ordinarily subject to a lease shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8).

§ 5c.103–2 Leases and industrial development bonds.

For purposes of section 103(b)(2), the determination of whether an obligation constitutes an industrial development bond shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8).

[T.D. 7800, 46 FR 63257, Dec. 31, 1981]

§ 5c.103–3 Leases and arbitrage.

In the case of a sale and leaseback transaction qualifying under section 168(f)(8), where the lessee's rental payments are substantially equal in timing and amount to the principal and interest payments on the lessor's note, the arbitrage provisions of section 103(c) and §§ 1.103–13, 1.103–14, and 1.103–15 shall apply to any obligations of the lessee (or party related to the lessee) without regard to the section 168(f)(8) lease transaction.

[T.D. 7800, 46 FR 63257, Dec. 31, 1981]

§ 5c.168(f)(8)–1 Special rules for leases.

(a) *In general.* Section 168(f)(8) of the Internal Revenue Code of 1954 provides special rules for characterizing certain agreements as leases and characterizing the parties to the agreement as lessors and lessees for Federal tax law purposes. These rules apply only with respect to qualified leased property. If all the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 are met, then the agreement shall be treated as a lease, and the party characterized as the lessor shall be treated as the owner of the property. In such case, the lessor shall be deemed to have entered into the lease in the course of carrying on a trade or business and shall be allowed accelerated cost recovery system (ACRS) deductions under section 168 and the investment tax credit under section 38 with respect to the leased property.

(b) *Exception for qualified research expenditures.* For purposes of section 44F(b)(2)(A)(iii), the determination of whether any amount is paid or incurred to another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8). Thus, if a lessee would be considered the owner of the property without regard to section 168(f)(8), any amounts paid by the lessee under the lease shall not be considered amounts paid or incurred for the right to use the property.

(c) *Other factors disregarded.* If an agreement meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11, the following

factors will not be taken into account in determining whether the transaction is a lease:

(1) Whether the lessor or lessee must take the tax benefits into account in order to determine that a profit is made from the transaction;

(2) The fact that the lessee is the nominal owner of the property for State or local law purposes (*e.g.*, has legal title to the property) and retains the burdens, benefits, and incidents of ownership (such as payment of taxes and maintenance charges with respect to the property);

(3) Whether or not a person other than the lessee may be able to use the property after the lease term;

(4) The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value at that time;

(5) The fact that the lessee or related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment); and

(6) The fact that the obligation of any person is subject to any contingency or offset agreement. See, for example, the rent and debt service offset in Example (2) of paragraph (e).

An agreement that meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 may be treated by the parties as a lease for Federal Tax law purposes only. Similarly, a sale by the lessee of the leased property to the lessor in a transaction where the property is leased back under an agreement that meets the requirements of section 168(f)(8) may be treated by the parties as a sale for Federal tax law purposes only. The agreements need not comply with State law requirements concerning transfer of title, recording, etc.

(d) *Ownership in one of the parties.* Notwithstanding any other section, if neither the lessor nor the lessee would be the owner of the property without regard to section 168(f)(8), or, if any party with an economic interest in the property (other than the lessor or lessee or any subsequent transferee of their interests) claims ACRS deductions or any investment tax credit with respect to the leased property, an election under section 168(f)(8) with respect to such property shall be void as of the date of the execution of the lease agreement.

(e) *Examples.* The application of section 168(f)(8) and §§ 5c.168(f)(8)–2 through 5c.168(f)(8)–11 may be illustrated by the following examples:

Example (1). X Corp. wishes to acquire a $1 million piece of equipment which is ''qualified leased property'' as defined in section 168(f)(8)(D). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Y Corp. is a person meeting the qualifications set forth in section 168(f)(8)(B)(i) and § 5c.168(f)(8)–3 and wishes to be the owner of the property for Federal tax law purposes. Y therefore purchases the equipment from the manufacturer for $1 million, paying $200,000 in cash and borrowing $800,000 from a bank (payable over 9 years and requiring nine equal annual payments of principal and interest of $168,000). Y then leases the equipment to X under an agreement providing for nine annual rental payments of $168,000, and the parties elect in accordance with the provisions of § 5c.168(f)(8)–2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made by X (the ''lessee-user'') under the lease will be exactly equal to the timing and amount of the principal and interest payments that Y (the ''lessor'') will be required to make to the bank under its purchase money note. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and the ACRS deductions with respect to the property. Y's basis in the property is $1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. The aggregate payments required to be made by X under the lease are treated as rent in accordance with § 5c.168(f)(8)–7 and are deductible as such.

Example (2). The facts are the same as in example (1) except that X purchases the equipment for $1 million and wishes to transfer ownership of the property for Federal tax law purposes to Y under a sale and leaseback arrangement. Accordingly, X sells the property to Y for $200,000 in cash (which represents the agreed upon compensation for the tax benefits to be enjoyed by Y as lessor) plus a 9-year, $800,000 note calling for nine $168,000 annual payments of principal and interest. Y then leases the property back to X under an agreement providing for nine annual rental payments of $168,000. The parties elect in accordance with the provisions of § 5c.168(f)(8)–2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made

by X (as the lessee-user) under the lease will be exactly equal to the timing and amount of the principal and interest payments that Y will be required to make to X under Y's purchase money note, so that the only cash transferred between X and Y is the $200,000 down payment. Y's obligation to make debt service payments on the note is contingent on X's obligation to make rental payments under the lease. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and ACRS deductions with respect to the property. Y's basis in the property is $1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. No gain or loss will be recognized by X on the sale of the property since the sale price equals X's basis in the property. X must report as income the interest paid by Y on the note and will be entitled to a deduction for the rental payments it makes under the lease in accordance with § 5c.168(f)(8)–7.

Example (3). Assume that in both examples (1) and (2) X has an option to purchase the equipment at the end of the lease term for $1.00. The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value is not taken into account in determining the status of the transactions as leases under section 168(f)(8).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56148, Nov. 13, 1981]

§ 5c.168(f)(8)–2 Election to characterize transaction as a section 168(f)(8) lease.

(a) *Election*—(1) *In general.* The election to characterize a transaction as a lease qualifying under section 168(f)(8) shall be made within the time and manner as set forth in this section without regard to section 168(f)(4).

(2) *Lease agreement.* For an agreement to be treated as a lease under section 168(f)(8) and this section, the lease agreement must be executed not later than 3 months after the property was first placed in service, as defined in § 5c.168(f)(8)–6(b)(2)(i) (or prior to November 14, 1981, if the property was first placed in service by the lessee after December 31, 1980, and before August 14, 1981). The agreement must be in writing and must state that all of the parties to the agreement agree to characterize it as a lease for purposes of Federal tax law and elect to have the provisions of section 168(f)(8) apply to the transaction. The agreement must also name the party who will be treated as the lessor and the party who will be treated as the lessee.

(3) *Information return concerning the election.* (i) Except as provided in subdivision (ii), for each lease agreement, the lessor and lessee must jointly file Form 6793, Safe Harbor Lease Information Return, concerning their election under section 168(f)(8). The information return must be signed by both the lessor and the lessee and filed not later than the 30th day after the agreement is executed with the Commissioner of Internal Revenue, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attn: Form 6793). Unless the failure to file timely is shown to be due to reasonable cause, the failure to file the information return timely shall void the section 168(f)(8) election as of the date of the execution of the lease agreement. The information return shall include the following items:

(A) The name, address, and taxpayer identifying number of the lessor and the lessee (and the common parent company if a consolidated return is filed);

(B) The service center with which the income tax returns of the lessor and lessee are filed;

(C) A description of each property with respect to which the election is made;

(D) The date on which the lessee places the property in service (determined as defined in § 5c.168(f)(8)–6(b)(2)(i)), the date on which the lease begins, and the term of the lease;

(E) The recovery property class of the leased property under section 168(c)(2) (for example, 5 years) and the ADR midpoint life of the leased property;

(F) The terms of the payments between the parties to the lease transaction;

(G) Whether the ACRS deductions and the investment tax credit are allowable to the same taxpayer;

(H) The aggregate amount paid to outside parties to arrange or carry out the transaction, such as, for example, legal and investment banking fees;

(I) For the lessor only: The unadjusted basis of the property as defined in section 168(d)(1);

(J) For the lessor only: If the lessor is a partnership or a grantor trust, the name, address, and taxpayer identifying number of the partners or the beneficiaries, and the Service Center with which the income tax return of each partner or beneficiary is filed; and

(K) Such other information as may be required by the return or its instructions.

The aggregate amount paid to outside parties which is described in paragraph (a)(3)(i)(H) of this section need not be disclosed unless it is reasonable to estimate that either the lessor or the lessee will lease property under section 168(f)(8) for the calendar year which has an aggregate adjusted basis to such person of more than $1,000,000. If either the lessor or the lessee reasonably expects to lease property with an aggregate basis of more than $1,000,000, then both parties must disclose their transaction costs.

(ii) In the case of an agreement executed before January 1, 1982, only the lessor is required to file the information return described in paragraph (a)(3)(i) of this section and the return must be postmarked not later than January 31, 1982. Unless the failure to file timely is shown to be due to reasonable cause, or unless the lessee files the information return postmarked by January 31, 1982, the lessor's failure to file the information return timely shall be a disqualifying event as of February 1, 1982, which shall cause an agreement to cease to be treated as a lease under section 168(f)(8). For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)–8.

(iii) A copy of the information return described in paragraph (a)(3) (i) and (ii) shall be filed by each party with its timely filed Federal income tax return for its taxable year during which the lease term begins. However, for taxable years ending in 1981 with respect to lease agreements executed during calendar year 1981, such statement shall be filed by the later of (A) the due date (taking extensions into account) of the party's 1981 Federal income tax return, or (B) where the filing of an amended return is required, with the amended return within 3 months following the execution of the lease agreement. For the requirement to file an amended return within 3 months and the consequences of the failure to so file, see § 5c.168(f)(8)–6(b)(2)(ii). A taxpayer that is required to file the information return with its Federal income tax return before an information return form is available shall file, in lieu of the required information return, a statement which contains the information set forth in subparagraphs (A) through (J) of pargraph (a)(3)(i). The failure by the lessor to file the information return (or, if applicable, the statement referred to in the preceding sentence) with its timely filed Federal income tax return shall be a disqualifying event which shall cause an agreement to cease to be treated as a lease under section 168(f)(8). For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)–8.

(4) *Election is irrevocable.* An agreement made pursuant to paragraph (a)(2) of this section shall be irrevocable as of the later of the date such agreement was executed or November 23, 1981.

(5) *Disposition by lessee.* Except in the case of transactions described in subparagraph (6), of this paragraph, if the lessee (or any transferee of the lessee's interest) sells or assigns its interest in the lease or in the property, the agreement will cease to be characterized as a lease under section 168(f)(8) as of the time of the sale or assignment unless the transferee furnishes to the lessor within 60 days following the transfer the transferee's written consent to take the property subject to the lease, and the transferee and lessor file a statement with their timely filed Federal income tax returns for the taxable year in which the transfer occurs containing the following information:

(i) The name, address, and taxpayer identifying number of the lessor and the transferee;

(ii) The district director's office with which the income tax returns of the lessor and transferee are filed;

(iii) A description of the property; and

(iv) Confirmation of the transferee's consent.

See § 5c.168(f)(8)–8 for the Federal income tax consequence where an agreement ceases to be characterized as a lease under section 168(f)(8).

(6) *Disposition of lessee's interest in bankruptcy, etc., or similar proceeding.* In the case of an agreement executed after May 31, 1982, where the lessee's interest in the lease or in the property is sold or assigned in a bankruptcy, liquidation, receivership, a court-supervised foreclosure, or in any similar proceeding for the relief or protection of insolvent debtors in Federal or State court, the agreement will continue to be characterized as a lease under section 168(f)(8) and the purchaser or assignee shall take the property subject to the lease if—

(i) Prior to the consummation of the sale or assignment, the lessor gives written notice of its Federal income tax ownership to the judicial or administrative body having jurisdiction over the proceeding and to the debtor in possession of the interest or, if at such time a trustee, receiver or similar person has been appointed by the court, to the person appointed. The notice must contain a request that the court and the debtor or the person appointed provide a copy of the notice to the purchaser or assignee prior to the consummation of the sale or assignment. Within 60 days following the sale or assignment, the lessor must provide notice of its Federal income tax ownership and copies of the lease agreement, and, in the case of a sale and leaseback transaction, the lessor's purchase money obligation, to the purchaser or assignee;

(ii) The lessor files a statement with its timely filed Federal income tax return for the taxable year in which the sale or assignment occurs containing the following information:

(A) The name, address, and taxpayer identifying number of the lessor and the purchaser or assignee;

(B) The district director's office with which the Federal income tax returns of the lessor and purchaser or assignee are filed;

(C) A description of the property; and

(iii) Prior to the consummation of the sale or assignment, all secured lenders of the lessee with interests in the property, which interests arose not later than the time the lessee first used the property under the lease (and which were perfected in accordance with applicable local law), specifically either exclude or release in writing the Federal income tax ownership of the property from their interests.

The purchaser or assignee of the interest with respect to which this paragraph applies shall file a statement with its timely filed Federal income tax return for the taxable year in which the sale or assignment occurs containing the information described in subdivision (ii) of this subparagraph. If the interest is subsequently transferred (other than in a bankruptcy, liquidation, receivership, court-supervised foreclosure, or similar proceeding) during the term of the lease, the agreement will continue to be characterized as a lease under section 168(f)(8) and the transferee will take the property subject to the lease if either (A) the lessor gives the transferee, prior to the transfer, a copy of the lease, written notice of its Federal income tax ownership, and, in the case of a sale and leaseback transaction, a copy of the lessor's purchase money obligation, and the lessor files a statement with its timely filed Federal income tax return as described in subdivision (ii) of this subparagraph, or (B) within 60 days following the transfer, the transferee agrees in writing to take the property subject to the lease and the lessor and transferee file a statement with their timely filed Federal income tax returns within the time and in the manner described in paragraph (a)(5) of this section. However, an agreement will not continue to be characterized as a lease under this subparagraph if, under another applicable provision, it would cease to be characterized as a lease. See § 5c.168(f)(8)–8 for the Federal income tax consequences where an agreement ceased to be characterized as a lease under section 168(f)(8).

(7) *Consequences of taking the property subject to the lease agreement.* For purposes of §§ 5c.168(f)(8)–1 through 5c168(f)(8)–11, in a situation where a transferee of a lessee's interest acquires the property subject to the lease, the transferee shall be deemed to have acquired a leasehold interest in the property equal to the remaining

lease term, any unpaid obligation of the lessor arising in connection with the sale of the property by the original lessee in a sale and leaseback transaction, and any option of the lessee to purchase the property. Any consideration paid by the transferee for the property shall be allocated to the lessor's obligation to the extent of the unpaid balance of the obligation. Any excess over the unpaid balance shall be allocated between the leasehold interest and the purchase option in proportion to their relative fair market values. As the new lessee, the transferee shall not be entitled to claim any ACRS deduction with respect to the property while the lease remains in effect and shall not be entitled to any investment tax credit with respect to the property. The transferee shall report interest income on the lessor's obligation, and shall be entitled to deduct the rent paid under the lease, in accordance with § 5c.168(f)(8)–7. In addition, the transferee shall be entitled to amortize the portion of its cost allocable to the leasehold interest. Coversely, as long as the lease remains in effect, the lessor will continue to be recognized as the owner of the property for Federal income tax purposes, shall be required to report rents due under the lease, and shall be entitled to deduct interest on its obligation.

(8) *Election to treat certain leases under subparagraph (6) rules.* The lessor under a section 168(f)(8) lease executed on or before May 31, 1982, may elect to have the provisions of paragraph (a)(6) of this section apply in the case of a sale or assignment of the lessee's interest in the lease or in the property in a bankruptcy, receivership, liquidation, court-supervised foreclosure, or similar proceeding. The election of the lessor with respect to any leased property may be made at any time prior to the consummation of any sale or assignment of such property in a bankruptcy, etc., or similar proceeding, by complying with the provisions of subparagraph (6) of this paragraph.

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

Example (1). X Corp. maintains its books and records for Federal tax law purposes on a calendar year basis. On February 1, 1981, X acquires certain equipment for use in its business, and the equipment is deemed to be placed in service on that date within the meaning of § 5c.163(f)(8)–6(b)(2)(i). On November 1, 1981, X sells the equipment to Y and leases it back under a lease in which the parties elect to have the provisions of section 168(f)(8) apply. The election is considered timely for purposes of making Y the owner of the property under section 168(f)(8) since the lease agreement was executed before November 14, 1981.

Example (2). The facts are the same as in example (1) except that X Corp.'s taxable year ends on February 28, 1981. X claimed the investment tax credit and depreciation deductions with respect to the property in its return filed April 1, 1981. The lease will qualify for safe harbor treatment under section 168(f)(8) provided X, within 3 months after the lease agreement was executed, files an amended return pursuant to § 5c.168(f)(8)–6(b)(2)(ii) for its taxable year ending February 28, 1981, in which X foregoes its right to claim any investment tax credit or ACRS deductions with respect to the property subject to the lease.

Example (3). X Corp. (as lessee) sells certain new equipment to Y Corp. (as lessor) and leases it back under a section 168(f)(8) lease. During the term of the lease X sells its interest in the property to T Corp. (other than in a bankruptcy or similar proceeding), and T does not give Y a written consent to take the property subject to the leased. The agreement ceases to be treated as a lease under section 168(f)(8) as of the date of the sale.

Example (4). The facts are the same as in example (3) except that the sale of the property takes place while X is under the jurisdiction of a court in a bankruptcy proceeding. All lenders of X having perfected interests in the property that arose by the time the property was first used under the lease have specifically either excluded or released the ownership of the property for Federal income tax purposes from their interests. Within the required time periods, Y gives appropriate notification to the court, the bankruptcy trustee, and T that the property is subject to the lease and files the required statement with its Federal income tax return for the taxable year in which the sale occurs. The agreement continues to be treated as a lease under section 168(f)(8). T will take the property subject to the lease. T must allocate the purchase price among the lessor's note, the leasehold interest, and the option (if any) to purchase the property.

Example (5). The facts are the same as in example (4), except that one lender of X having a perfected and timely interest in the property does not specifically exclude or release the Federal income tax ownership of the property from its interest. The agreement will cease to be treated as a lease

under section 168(f)(8) as of the date of the transfer to T. The result would be the same if Y failed to furnish any of the notices required by subdivision (i) of paragraph (a) and (6) or failed to file a statement as required by subdivision (ii) of paragraph (a)(6).

Example (6). The facts are the same as in example (4). In addition, during the term of the lease T transfers the property to U Corp. and Y fails to furnish U with written notice that the property is subject to the lease prior to the sale and U refuses to agree to consent to the lease agreement. The agreement will cease to be treated as a lease under section 168(f)(8) as of the date of the transfer to U. The result would be the same if Y furnished U with timely written notice of its tax ownership but failed to file the required statement with its tax return for its taxable year in which the sale occurred.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56148, Nov. 13, 1981; T.D. 7800, 46 FR 63257, Dec. 31, 1981]

§ 5c.168(f)(8)–3 Requirements for lessor.

(a) *Qualified lessor.* In order for an agreement to be treated as a lease under section 168(f)(8), the party characterized in the agreement as the lessor must be a qualified lessor. The term ''qualified lessor'' means—

(1) A corporation which is neither an electing small business corporation under section 1371(b) nor a personal holding company under section 542(a), or

(2) A partnership all of whose partners are corporations described in subparagraph (1), or

(3) A grantor trust whose grantor and beneficiaries are all corporations described in paragraph (a)(1) or partnerships described in paragraph (a)(2).

(b) *Effect of disqualification of lessor.* If at any time during the term of the agreement the lessor ceases to be a qualified lessor, the agreement will lose its characterization as a lease under section 168(f)(8) as of the date of the event causing such disqualification. If any partner of a partnership described in paragraph (a)(2) ceases to be a corporation described in paragraph (a)(1), the partnership entity shall cease to be a qualified lessor. Similarly, if any beneficiary of a trust described in paragraph (a)(3) ceases to be a corporation described in paragraph (a)(1), the trust shall cease to be a qualified lessor. See § 5c.168(f)(8)–8 for the Federal income tax consequences of such a disqualification.

(c) *One tax owner per property.* Only one person may be a qualified lessor under section 168(f)(8) with respect to leased property. Thus, property that is subject to a lease under section 168(f)(8) may not be subleased under a lease for which a section 168(f)(8) election is made. In addition, if a lessor sells or assigns in a taxable transaction its interest in a section 168(f)(8) lease or in the underlying property, the lease shall cease to qualify under section 168(f)(8) and no other lease may be executed under section 168(f)(8) with respect to the property. The preceding sentence applies to a sale or assignment of its interest by a partner of a lessor that is a partnership described in paragraph (a)(2) of this section or by a beneficiary of a lessor that is a trust described in paragraph (a)(3) of this section. See § 5c.168(f)(8)–8 for the Federal income tax consequences where a lease ceases to qualify under section 168(f)(8). However, lease brokers, agents, etc., may, for example, prepare executory contracts with the lessee whereby the broker's assignee may execute a lease as lessor, and, if the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–1 through 5c.168(f)(8)–11 are met, the lease will qualify under section 168(f)(8).

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

Example (1). X Corp. (as lessee) sells certain new equipment to Y Corp. (as lessor) and leases it back under a section 168(f)(8) lease. Within 3 months after the property was placed in service, Y assigns its interest in the lease to Z. Upon the transfer to Z, the lease will no longer qualify for treatment under section 168(f)(8). The property may not thereafter be the subject of a section 168(f)(8) lease.

Example (2). X Corp., which wishes to acquire certain equipment for use in its business and to transfer ownership of the property for Federal income tax law purposes, purchases the equipment and enters into an executory contract with LB, a lease broker, under which X agrees to execute a section 168(f)(8) lease as lessee with a third party lessor. At a later date (but within the prescribed 3-month period), LB arranges for X and T Corp. (which wishes to secure Federal income tax law ownership) to execute a lease agreement in accordance with § 5c.168(f)(8)–2.

The lease will qualify for treatment under section 168(f)(8).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56149, Nov. 13, 1981]

§ 5c.168(f)(8)–4 Minimum investment of lessor.

(a) *Minimum investment.* Under section 168(f)(8)(B)(ii), an agreement will not be characterized as a lease for purposes of section 168(f)(8) unless the qualified lessor has a minimum at risk investment which, at the time the property is placed in service under the lease and at all times during the term of the lease, is not less than 10 percent of the adjusted basis of the leased property. As the adjusted basis of the leased property is reduced by capital cost recovery deductions, the minimum investment required will also be reduced to 10 percent of the revised adjusted basis, until the adjusted basis has been completely recovered, at which time no minimum investment will be required. Financing provided by the lessee or a party related to the lessee, such as a recourse note given by the lessor to the lessee, will not be taken into account in determining the lessor's minimum investment.

(b) *At risk amount.* The minimum investment which the lessor has at risk with respect to the leased property for purposes of paragraph (a) of this section includes only consideration paid and recourse indebtedness incurred by the lessor to purchase the property. The lessor must have sufficient net worth (without regard to the value of any leases which qualify under section 168(f)(8)) to satisfy any personal liability incurred. Any tax benefits which the lessor derives from the leased property shall not be taken into account to reduce the amount the lessor has at risk. An agreement between the lessor and the lessee requiring either or both parties to purchase or sell the qualified leased property at some price (whether or not fixed in the agreement) at the end of the lease term shall not affect the amount the lessor has at risk with respect to the property. However, an option held by the lessor to sell the property that is exercisable before the end of the period prescribed under section 168(c)(2) for the recovery property class of the leased property (taking into account any election by the lessor or lessee under section 168(b)(3)) shall reduce the amount the lessor is considered to have at risk by the amount of the option price at the time the option becomes exercisable.

§ 5c.168(f)(8)–5 Term of lease.

(a) *Term of lease—Basic rules.* To qualify as a lease under section 168(f)(8) and § 5c.168 (f)(8)–1 (a), the lease agreement must provide for a term that does not exceed the maximum term described in paragraph (b) of this section; such term must also at least equal the minimum term described in paragraph (c).

(b) *Maximum term.* For purposes of section 168(f)(8)(B)(iii) and this section, the term of the lease may not exceed the greater of—

(1) 90 percent of the useful life of the property under section 167, or

(2) 150 percent of the asset depreciation range (ADR) present class life (''midpoint'') of such property, applicable as of January 1, 1981 (without regard to section 167(m)(4)), published in Rev. Proc. 77–10, 1977–1 C. B. 548, and revisions thereto.

Solely for purposes of this paragraph (b), ''useful life'' means the period when the leased asset can reasonably be expected to be eonomically useful in anyone's trade or business; such term does not mean the period during which the lessor expects to lease the property. Any option to extend the term of the lease, whether or not at fair market value rent, must be included in the term of the lease for purposes of this paragraph. If several different pieces of property are the subject of a single lease, the maximum allowable term for such lease will be measured with respect to the property with the shortest life. In no case, however, will the lease term qualify under this section if such term with respect to any piece of property is less than the minimum term described in paragraph (c).

(c) *Minimum term.* For purposes of this section, the term of the lease must at least equal the period prescribed under section 168(c)(2) for the recovery property class of the leased property. For example, if a piece of leased equipment is in the 5-year recovery property class, the lease agreement must have a

minimum term of 5 years. In general, the determination of whether property is 3-year recovery property, 5-year recovery property, etc., in the hands of the lessor will be based on the characterization of the property in the hands of the owner as determined without regard to the section 168(f)(8) lease. Thus, for example, property which is public utility property or RRB replacement property absent the section 168(f)(8) lease will be characterized as such in the hands of the lessor for purposes of section 168(f)(8). However, with respect to RRB replacement property, the transitional rule of section 168(f)(3) shall be inapplicable to the lessor. In addition, any election under section 168(b)(3) by the lessor with respect to the class of recovery property to which the qualified leased property is assigned shall apply to the leased property in determining the term of the lease. A lease term that does not exceed the term required to satisfy the minimum lease term of this paragraph will be deemed to comply with the maximum lease term described in paragraph (b) if such minimum lease term exceeds such maximum lease term.

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

Example (1). X Corp. (as lessee) and Y Corp. (as lessor) enter into a lease which they elect to be treated under section 168(f)(8) with respect to a chemical manufacturing facility that will also generate steam for use in the production of electricity. The assets comprising the chemical plant are described in ADR guideline class 28.0 (midpoint life of 9.5 years), and the assets comprising the steam plant are described in ADR class 00.4 (midpoint life of 22 years). To satisfy the maximum lease term requirement of section 168(f)(8)(B)(iii)(II) and § 5c.168 (f)(8)–5(b), the lease term may not exceed 14.25 years (150 percent of the 9.5 year midpoint life of the chemical plant).

Example (2). The facts are the same as in example (1) except that the chemical plant and the steam plant are the subject of separate leases. For purposes of section 168(f)(8)(B)(iii)(II) and § 5c.168(f)(8)–5 (b), the maximum term of the lease with respect to the chemical plant is 14.25 years (150 percent of 9.5 years) and the maximum term of the lease with respect to the steam plant is 33 years (150 percent of 22 years).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981; 50 FR 13020, Apr. 2, 1985]

§ 5c.168(f)(8)–6 Qualified leased property.

(a) *Basic rules*—(1) *In general.* An agreement shall be treated as a section 168(f)(8) lease only if the property which is leased is qualified leased property. Qualified leased property is recovery property as defined in section 168(c) and is either—

(i) Except as provided in subparagraph (2), new section 38 property of the lessor which is leased no later than 3 months after the date the property was placed in service (or prior to November 14, 1981, if the property was placed in service after December 31, 1980, and before August 14, 1981) and which, if acquired by the lessee, would have been new section 38 property of the lessee, or

(ii) Property which is a qualified mass commuting vehicle (as defined in section 103(b)(9)) and which is financed in whole or in part by proceeds from an issue of obligations the interest on which is excludable from income under section 103(a).

(2) *Sale and leaseback arrangement.* (i) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not be qualified leased property unless the property was (or would have been) new section 38 property of the lessee and was purchased and leased no later than 3 months after the date the property was placed in service by the lessee (or prior to November 14, 1981, if the property was placed in service by the lessee after December 31, 1980 and before August 14, 1981) and with respect to which the lessor's adjusted basis does not exceed the adjusted basis of the lessee (or a party related to the lessee) at the time of the lease. If the lessor's adjusted basis in the property exceeds the seller's adjusted basis with respect to the property at the beginning of the lease, the property will not be qualified leased property.

(ii) For purposes of this paragraph (a)(2) and paragraph (b)(3)(ii) of this section, transactional costs with respect to a sale and leaseback arrangement that are not currently deductible shall be allocated to the lease agreement (and not included in the lessor's

adjusted basis with respect to the property) and amortized over the term of the lease. These costs include legal and investment banking fees and printing costs.

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

Example (1). X, an airline, contracts to have an airplane constructed for a fixed price of $10 million. Prior to completion of construction of the airplane, the value of the airplane increases to $11 million. X buys the airplane at the contract price of $10 million and, before it is placed in service, sells the airplane at its fair market value of $11 million to Y and then leases it back. The lease will not qualify for safe harbor protection under section 168(f)(8) because the lessor's adjusted basis in the airplane exceeds the lessee's adjusted basis. This result obtains even though the airplane qualifies as new section 38 property of X airline.

Example (2). Assume the same facts as in example (1) except that, prior to completion of the construction of the airplane, X assigns its contract to Y for $1 million, and Y thereafter buys the airplane at the contract price of $10 million. The acquisition by Y is treated as an indirect purchase from the lessee. Because Y's adjusted basis in the airplane would exceed the lessee's adjusted basis, the lease will not qualify under section 168(f)(8).

(b) *Special rules*—(1) *New section 38 property*. (i) new section 38 property is section 38 property described in subsection (b) of section 48 and the regulations thereunder other than a qualified rehabilitated building (within the meaning of section 48(g)(1)). Qualified leased property must be new section 38 property at the beginning of the lease and must continue to be section 38 property in the hands of the lessor and the lessee throughout the lease term. The fact that the lessee used the property within the 3-month period prior to the lease will not disqualify the property as new section 38 property of the lessee.

(ii) The application of this paragraph (b)(1) may be illustrated by the following examples:

Example (1). N is a hospital exempt from Federal income tax and wishes to purchase certain equipment for use in furtherance of its exempt functions (*i.e.,* other than for use in an unrelated trade or business). O, a qualified lessor as defined in § 5c.168(f)(8)–3(a), acquires the property and leases it to N. Since the equipment would not be new section 38 property of N if N had acquired it by virtue of section 48(a)(4) (relating to exception from definition of section 38 property for certain property used by certain tax-exempt organizations), the equipment is not qualified leased property and the lease does not qualify under section 168(f)(8). Whether O is considered the owner of the property for Federal tax law purposes will be determined without regard to the provisions of section 168(f)(8).

Example (2). P Corp. is constructing progress expenditure property as defined in section 46(d)(2) for R Corp. Progress expenditure property is property which it is reasonable to believe will be section 38 property in the hands of the taxpayer when it is placed in service. Before the date that the property is placed in service (as defined in § 5c.168(f)(8)–6(b)(2)(i)), the property is not new section 38 property. Accordingly, progress expenditure property cannot be qualified leased property.

Example (3). R Corp., a foreign railroad, acquires new rolling stock and enters into a sale and leaseback transaction with B Corp., a domestic corporation. R uses the rolling stock within and without the United States, but predominantly outside the United States within the meaning of section 48(a)(2)(A). Section 48(a)(2)(B)(ii) is inapplicable to R because R is neither a domestic railroad corporation nor a United States person; therefore, the rolling stock cannot be section 38 property to R. The property is not qualified leased property.

(2) *Placed in service.* (i) Property shall be considered as placed in service at the time the property is placed in a condition or state of readiness and availability for a specifically assigned function. If an entire facility is leased under one lease, property which is part of the facility will not be considered placed in service under this rule until the entire facility is placed in service. If the lessee claims any investment tax credit or ACRS deductions with respect to any component which is part of an entire facility that is subsequently leased, the lessee must file an amended return within the time prescribed in paragraph (b)(2)(ii) of this section in which it foregoes its claim to the investment tax credit and ACRS deductions. If such amended return may not be filed because the time for filing a claim for refund with respect to any component under section 6511 has expired, each component of the facility will be considered as placed in service at the time the individual component is placed in a condition or state of

readiness and availability for a specifically assigned function and not when the entire facility is placed in service.

(ii) For purposes other than determining whether property is qualified leased property, property subject to a lease under section 168(f)(8) will be deemed to have been placed in service not earlier than the date such property is used under the lease. If the lessee claims any investment tax credit or ACRS deductions with respect to property placed in service under a lease, the lessee must file an amended return within 3 months following the execution of the lease agreement in which the lessee foregoes its claim to the investment tax credit and ACRS deductions with respect to the leased property or the election under section 168(f)(8) will be void.

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

Example (1). X Corp. acquires equipment on December 31, 1982, and places the equipment in service. X's taxable year ends December 31. On March 20, 1983, X sells the equipment to Y Corp. and leases it back in a transaction that qualifies under section 168(f)(8). The property is considered to be new section 38 property to X under paragraph (b)(1). X is not allowed any investment tax credit or ACRS deductions with respect to the property in 1982 because the property is not considered to have been placed in service for purposes other than determining whether it is qualified leased property until it is used under the lease under subdivision (ii) of this subparagraph (2). If X has claimed credits or deductions on its 1982 return, it must file an amended return for 1982 within 3 months following the execution of the lease agreement or the election will be void.

Example (2). In March 1985, K Corp. completes reconditioning of a machine, which it constructed and placed in service in 1982 and which has an adjusted basis in 1985 of $10,000. The cost of reconditioning amounts to an additional $20,000. K would be entitled to a basis of $20,000 in computing its qualified investment in new section 38 property for 1985. In May 1985, K enters into a sale and leaseback transaction with L Corp. with respect to the reconditioned parts of the machine that are new section 38 property to K. K and L elect to have section 168(f)(8) apply. Assuming that the adjusted basis of the leased property is the same to L as it is to K, the property qualifies as qualified leased property under section 168(f)(8)(D)(ii) and L is considered the tax owner of the property. Since, for purposes other than determining whether property is qualified leased property, the property is deemed originally placed in service not earlier than the date the property is used under the lease, the property is new section 38 property to L and L may claim the investment tax credit (and ACRS deductions) with respect to the leased property.

(3) *Qualified mass commuting vehicle.* (i) A qualified mass commuting vehicle as defined in section 103(b)(9) will constitute qualified leased property for purposes of section 168(f)(8)(D)(iii) and this section provided all of the following requirements are met:

(A) At least part (as, for example, 5 percent) of the financing for the purchase of such vehicle must be derived from proceeds of obligations the interest on which is excludable from income under section 103(a)(1) (whether or not such obligations are described in section 103(b)(4)(I));

(B) The vehicle must be recovery property (*i.e.,* it must have been first placed in service by the lessee after December 31, 1980); and

(C) The vehicle must not have been previously leased under a section 168(f)(8) lease by the lessee.

A qualified mass commuting vehicle that is qualified leased property may be leased under section 168(f)(8) at any time after December 31, 1980. The requirement of paragraph (b)(3)(i)(A) of this section may be satisfied where the vehicles leased under a section 168(f)(8) lease are refinanced with proceeds of an obligation the interest on which is excludable from income under section 103(a)(1).

(ii) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not qualify under this subsection unless the lessor's adjusted basis in the property does not exceed the adjusted basis of the lessee (or related party) at the time of the execution of the lease. The adjusted basis of property to a lessee (or related party) shall be determined under Part II of Subchapter O of Chapter I of the Code for purposes of determining gain, except that the adjustment described in section 1016(a)(3) and §1.1016–4 need not be made for property acquired during calendar year 1981 and leased no later than March 1, 1982.

(iii) In a transaction characterized as a lease under section 168(f)(8), the lessor's adjusted basis may not include that portion, if any, of the cost of the vehicle to the lessee (or related party) that is financed, directly or indirectly, with an Urban Mass Transportation Administration (UMTA) grant (excluding a grant under the interstate transfer provision of the Federal-Aid Highway Act (FAHA)), a FAHA grant, or any other Federal grant. Where a vehicle is included as part of an UMTA-funded project, 80 percent of the vehicle's cost will be deemed to be financed with an UMTA grant and 20 percent will be deemed to be financed from non-Federal sources without regard to whether the UMTA funds or the non-Federal funds are traceable to any particular vehicle included within the project. For purposes of this subparagraph and paragraph (b)(3)(ii) of this section, amounts originating from non-Federal sources which are paid or incurred with respect to leased property by a State or political subdivision of the State (or political subdivision created by the joint authorization of two or more States) shall be taken into account in computing the lessee's adjusted basis in the leased property as if the lessee had paid or incurred such amounts.

(iv) If a vehicle is purchased pending approval of an UMTA grant, the lessor's unadjusted basis in the vehicle may equal the lessee's unadjusted basis unreduced by any subsequently approved UMTA grant; however, if an UMTA grant is later approved and the vehicle is included as part of an UMTA-funded project, except as provided hereinafter in this subparagraph, the lease shall terminate with respect to an undivided 80 percent interest in the vehicle. For the Federal income tax consequences of the termination of a lease, see §5c.168(f)(8)–8. If such a subsequently approved UMTA grant is used to purchase additional qualified mass commuting vehicles, the portion of each vehicle deemed to be allocable to non-UMTA financing (*i.e.*, 20 percent) may be leased under section 168(f)(8). If a vehicle is purchased pending approval of an UMTA grant and leased under section 168(f)(8), the lease will not be deemed to have terminated with respect to 80 percent of the vehicle when the UMTA grant is later approved if the total interest leased before the grant is approved did not exceed 20 percent of the lessee's adjusted basis in the vehicle (unadjusted basis prior to March 1, 1982) unreduced by any subsequently approved UMTA grant. For purposes of this subparagraph and paragraph (b)(3)(iii) of this section, the allocation principles applicable to UMTA grants shall apply in the case of FAHA grants except that 85 percent and 15 percent shall be substituted for 80 percent and 20 percent, respectively. Similar allocation rules shall also apply to other Federal grants used to finance the acquisition of qualified mass commuting vehicles.

(v)(A) Notwithstanding the provisions of §5c.168(f)(8)–2(a)(3)(iii), the lessee in a transaction to which this paragraph (b)(3) applies is not required to file an information return or a statement concerning its election under section 168(f)(8).

(B) Notwithstanding the provisions of §5c.168(f)(8)–2(a)(5), if the transfer of a qualified mass commuting vehicle is not otherwise a disqualifying event, the transferee is not required to file the statement mentioned therein.

(C) The fact that a qualified mass commuting vehicle is not section 38 property because it is used by an exempt entity will not disqualify the lease under §5c.168(f)(8)–8(b)(4); however, a disqualifying event will occur, and the agreement will cease to be characterized as a lease under section 168(f)(8), with respect to a vehicle which (*1*) ceases to be a qualified mass commuting vehicle or (*2*) would cease to be section 38 property if used by a taxable entity as, for example, a vehicle used predominantly outside the United States. For the Federal income tax consequences of a disqualifying event, see §5c.168(f)(8)–8.

(vi) The lessor of a qualified vehicle will not be allowed an investment tax credit with respect to it under section 38.

(vii) The application of this paragraph (b)(3) may be illustrated by the following examples:

Example (1). On July 1, 1981, a unit of city X, X Transit Authority (XTA), purchases 100 buses after receiving an UMTA grant for 80

percent of their purchase price. Fifteen percent of the purchase price is financed with a combination of State and local governmental grants and 5 percent is financed with proceeds from an issue of tax-exempt obligations described in section 103(b)(4)(I). Because UMTA financed an 80 percent interest in the 100 buses, XTA may lease under section 168(f)(8) only a 20 percent interest in each bus. If XTA were to lease 100 percent of 20 buses, only 20 percent of such buses would be deemed to be leased under a safe harbor lease.

Example (2). The facts are the same as in example (1) except that UMTA has not yet approved XTA's application in 1981. Pending the UMTA approval, XTA purchases and places in service 20 buses in July 1981. The 20 buses are financed with tax-exempt obligations described in section 103(b)(4)(I). On December 15, 1981, XTA sells a 100 percent interest in these 20 buses to Corporation M and leases them back under a lease in which the parties elect to have the provisions of section 168(f)(8) apply. M is a calendar-year taxpayer and claims an ACRS deduction with respect to the buses on its return for taxable year 1981. On July 1, 1982, UMTA approves XTA's grant application, thus enabling XTA to purchase an additional 80 buses. Because 80 percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982, the safe harbor lease terminates with respect to an undivided 80 percent interest in the 20 buses. If XTA would be considered the owner of the buses without regard to section 168(f)(8), the termination will result in a deemed sale of an undivided 80 percent interest in the 20 buses by M to XTA. The amount realized by M on the sale will include a proportionate part of the outstanding amount of M's debt plus the sum of any other consideration received by M. M will realize gain or loss, depending upon its basis, with applicable section 1245 recapture. However, XTA may lease the 20 percent interest in the 80 new buses it purchased in 1982 which is deemed to have been financed with non-Federal funds.

Example (3). The facts are the same as in example (2) except that the grant approved by UMTA is used to purchase and renovate a bus garage facility. Eighty percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982. The lease would still terminate with respect to an undivided 80 percent interest in the vehicles. XTA cannot lease the garage facility under 168(f)(8) because it does not constitute a qualified mass commuting vehicle.

Example (4). The facts are the same as in example (2) except that on December 15, 1981, XTA sells and leases back only a 20 percent interest in the 20 buses acquired in July 1981. When the UMTA grant is later approved, the lease will not terminate with respect to any portion of the 20 buses. In addition, XTA may lease the 20 percent interest in the 80 new buses purchased in 1982 and deemed to have been financed with non-Federal funds.

Example (5). On August 1, 1982, UMTA approves a grant for a major 5-year capital expenditure program to improve city Y's rapid rail transit system. None of the funds relating to this UMTA-funded project, provided either by UMTA or by city Y, will be used to purchase qualified mass commuting vehicles. Instead, a number of rapid rail cars and buses will be purchased entirely with funds provided with a combination of grants by the State and city governments and of proceeds from an issue of tax-exempt obligations described in section 103(a). Because none of the rapid rail cars and buses are included as part of the UMTA-funded project, no part of them is deemed to be financed by UMTA. If at least 5 percent of the cost of the qualified mass commuting vehicles is provided by tax exempt obligations under section 103(a), the vehicles will be qualified leased property in their entirety.

Example (6). City Z has a mass transit agency (ZTA) which purchases on July 1, 1982, 10 buses for which it pays $1,000,000, 95 percent of which is derived from grants from city Z and 5 percent from tax exempt obligations described in section 103(a). The buses have a useful life within the meaning of § 1.167(a)–1(b) of 10 years and their salvage value is zero. On July 1, 1983, ZTA sells these buses to corporation P and leases them back in a transaction which the parties elect to have treated as a lease under section 168(f)(8). At the time of the sale and leaseback, ZTA's adjusted basis in the 10 buses under section 1016(a)(3) and § 1.1016–4 is $900,000 ($1,000,000 cost less $100,000 of depreciation sustained, computed on a stright-line basis). Before the transaction will qualify under section 168(f)(8) and § 5c.168(f)(8)–6(b)(3)(ii), P's adjusted basis in the vehicles may not exceed ZTA's basis, or $900,000.

Assuming that the transaction qualifies under section 168(f)(8) and that corporation P is a calendar year taxpayer, P may claim ACRS deductions for 1982 of $135,000 (15 percent of $900,000).

Example (7). The facts are the same as in example (6) except that the sale and leaseback transaction is closed on December 31, 1982. P's adjusted basis in the vehicles may not exceed ZTA's basis, or $950,000 ($1,000,000 cost less $50,000 of depreciation sustained, computed on a straight-line basis).

Example (8). The facts are the same as in example (6) except that ZTA purchases the buses on June 1, 1981, and enters into the sale and leaseback transaction with corporation P on December 31, 1981. Under § 5c.168(f)(8)–6(b)(3)(ii), no adjustment is made to ZTA's basis in the buses for depreciation sustained. Therefore, P's basis in the buses may equal ZTA's cost of $1,000,000.

Example (9). On July 1, 1981, a unit of city W, W Transit Authority (WTA), purchases 100 buses with local grants derived entirely from a city W sales tax. The buses do not constitute qualified leased property under §5c.168(f)(8)–6(b)(3) because no part of the financing for their purchase was derived from the proceeds of tax exempt obligations.

Example (10). The facts are the same as in example (9) except that on November 1, 1981, WTA borrows 5 percent of the cost of the buses and pledges them as security. The interest on WTA's obligation is excludable from income under section 103(a)(1). On December 31, 1981, WTA sells to T Corp. all 100 buses and leases them back. Under §5c.168(f)(8)–6(b)(3)(i), each bus is deemed to be financed with the proceeds of tax exempt obligations. Therefore, if the vehicles otherwise meet the definition of qualified leased property, all the vehicles will be qualified leased property under this section.

(4) *Foreign lessees.* In addition to the other provisions of this section, property which is leased under a section 168(f)(8) lease to a foreign person shall not be qualified leased property unless the gross income attributable to the property from all sources (determined without regard to section 872(a) or 882(b)) is effectively connected with a trade or business within the United States, and the taxable income, if any, attributable to the property is subject to tax under section 871(b)(1) or 882(a)(1). For this purpose, if income attributable to the property is not included in gross income of a foreign lessee, and is exempt from taxation, under sections 872 or 833, or if the income is otherwise exempt from taxation under any income tax convention to which the United States is a party, then the property shall not be qualified leased property.

(5) *Other rules.* (i) Qualified leased property may include undivided interests in property or property regardless of whether or not it is considered separate property under State or local law. If property subject to a section 168(f)(8) lease is later determined not to be qualified leased property, disqualification of the lease under section 168(f)(8) will apply only as to that property.

(ii) The application of this paragraph (b)(5) may be illustrated by the following examples:

Example (1). On July 1, 1981, X Corp. contracts to have a manufacturing facility constructed for use in its business. Construction of the facility is completed on July 1, 1982, and the facility is deemed to be placed in service as of that date under §5c.168(f)(8)–6(b)(2)(i). The facility is comprised of a mixture of new section 38 property and buildings that do not qualify as section 38 property. On August 1, 1982, X sells the new section 38 property in the facility to Y and leases it back under an agreement in which the parties elect to be treated as a lease described in section 168(f)(8). Assuming that the other requirements of this paragraph are met, the new section 38 property contained in the facility will be qualified leased property. If it is later determined that property subject to the section 168(f)(8) lease is not new section 38 property (and thus not qualified leased property), the safe harbor protection will be lost only as to that property.

Example (2). X Corp. acquires a certain piece of equipment (which is new section 38 property) for use in its business. Within 3 months, X sells a 70 percent undivided interest in the property to lessor A and a 10 percent undivided interest in the property to lessor B and leases both portions back under separate section 168(f)(8) leases. The investment tax credit and ACRS deductions associated with the property will be divided among X, lessor A, and lessor B, on a basis of 20 percent, 70 percent, and 10 percent, respectively.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981; T.D. 7800, 46 FR 63258, Dec. 31, 1981]

§5c.168(f)(8)–7 Reporting of income, deductions and investment tax credit; at risk rules.

(a) *In general.* The fact that the lessor's payments of interest and principal and the lessee's rental payments under the lease are not equal in amount will not prevent the lease from qualifying under section 168(f)(8). However, see paragraph (b) for special requirements in sale and leaseback transactions. In determining the parties' income, deductions, and investment tax credit under the lease, the rules in paragraphs (c) through (g) of this section shall apply regardless of the overall method of accounting otherwise used by the parties.

(b) *Requirements for sale and leaseback transaction.* If the property leased is financed by the lessee (or a related party of the leasee) in a sale and leaseback transaction, the lease will not qualify under section 168(f)(8) unless—

(1) The term of the lessor's purchase money obligation is coterminous with the term of the lease, and

(2) The lessor's obligation bears a reasonable rate of interest. For this purpose, a rate of interest shall be presumed to be reasonable if, on the date the agreement is executed, it is within 3 percentage points of (i) the rate in effect under section 6621, the prime rate in effect at any local commercial bank, or the most recent applicable rate determined by the Secretary under § 1.385–6 (e)(2)(i), or (ii) an arm's-length rate as defined in § 1.482–2, or (iii) any rate between any two of the rates described by subdivisions (i) and (ii) of this paragraph(b)(2).

(c) *Interest deductions and income*—(1) *Deductibility from income.* In determining the amount of interest that a lessor may deduct in a taxable year with respect to its purchase money obligation given to the lessee or to a third party creditor, the lessor may not claim a deduction that would be—

(i) Greater than a deduction that would be allowed to an accrual basis taxpayer under a level-payment mortgage, amortized over a period equal to the term of the lessor's obligation, or

(ii) Less than a deduction that would be allowed to an accrual basis taxpayer under a straight line amortization of the principal over the term of the lessor's obligation.

In cases in which the property is not financed by the lessee or a party related to the lessee, the computation of the interest deduction may take into account fluctuations in the interest rate which are dependent on adjustments in the prime rate or events outside the control of the lessor and the third party creditor.

(2) *Includibility in income.* The lessee shall include interest on the lessor's purchase money obligation in income at the same time and in the same amount as the lessor's interest deductions, as determined under paragraph (c)(1).

(d) *Rental income and deductions*—(1) *Deductibility from income.* The amount of the lessee's rent deduction under a section 168(f)(8) lease with respect to any taxable year shall be a pro rata portion of the aggregate amount required to be paid by the lessee to the lessor under the terms of the lease agreement. If the lessee is required to purchase the leased property at the end of the lease term, of if the lessor has an option to sell the property to the lessee, rent shall not include the lesser of—

(i) The amount of the lessee's purchase obligation, whether fixed by the terms of the lease agreement or conditioned on the exercise of the lessor's option to sell the property to the lessee, or

(ii) The fair market value of the property at the end of the lease term determined at the beginning of the lease term.

For this purpose, fair market value shall be determined without taking into account any increase or decrease for inflation or deflation during the lease term. Rent deductions may be adjusted pursuant to the terms of the lease agreement to account for fluctuations which are dependent on events outside the control of the lessor and lessee, such as a change in the interest rate charged by a third party creditor of the lessor on the debt incurred to finance the purchase of the leased property.

(2) *Includibility in income.* The lessor shall include rent in income as follows:

(i) In the case of prepayments of rent, the earlier of when such rent is paid by the lessee or accrued under the lease, and

(ii) In the case of other rent, at the same time and in the same amount as the lessee's rent deductions, as determined under paragraph (d)(1).

(e) *ACRS deductions.* The deductions that the lessor is allowed under section 168(a) with respect to property subject to a section 168(f)(8) lease shall be determined without regard to the limitation in section 168(f)(10)(B)(iii). The recovery class of qualified leased property in the hands of the lessor shall be determined by the character of the property in the hands of the owner of the property without regard to section 168(f)(8). Any elections under section 168(b)(3) by the lessor with respect to the class of recovery property to which the qualified leased property is assigned shall apply to the leased property. However, with respect to RRB replacement property, the transitional rule of section 168(f)(3) shall be inapplicable to the lessor.

(f) *At risk requirements.* The amount of the investment credit and ACRS deductions that a lessor shall be allowed with respect to the leased property shall be limited to the extent the at risk rules under the investment tax credit provisions and section 465 apply to the lessee or to the lessor. In determining the amount the lessee would be at risk, the at risk rules will be applied as if the lessee had not elected to have section 168(f)(8) apply. Thus, for example, if, without regard to section 168(f)(8), an individual lessee would be treated as the owner of the leased property for Federal tax law purposes, the lessor under a section 168(f)(8) lease would be allowed ACRS deductions or investment tax credits with respect to the property only to the extent that the lessee may have claimed them had the parties not elected treatment under section 168(f)(8). In addition, the ACRS deductions and investment tax credits that a lessor is allowed with respect to the property are further limited to the extent that the at risk rules apply to the lessor as owner of the property under the section 168(f)(8) lease. If the lessor and the lessee are subject to the at risk rules, the lessor is allowed only the lesser of the ACRS deductions and investment tax credits allowable to the lessor and the lessee.

(g) *Limitation on section 48(d) amount.* If in a sale and leaseback transaction the lessor elects pursuant to section 48(d) to treat the lessee (which is the user of the property) as having acquired the property for purposes of claiming the investment tax credit, the lessee shall be treated as acquiring the property for an amount equal to the basis of the property to the lessor (and not for an amount equal to its fair market value). The investment tax credit allowable to the lessee is further limited to the extent the at risk rules apply to either the lessor or to the lessee. See paragraph (f) of this section.

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

Example (1). Y, a qualified lessor, acquires a piece of equipment which is qualified leased property for $1 million and leases it to X under a lease which the parties properly elect to have characterized as a lease described in section 168(f)(8). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Under the terms of the lease, X, the lessee-user, is obligated to pay Y nine annual payments of $10,000 and, at the end of the lease term, Y has the option to sell the property to X for $2,160,000. Under §5c.168(f)(8)–7(d), the aggregate payments required to be made by X under the lease are $2,250,000 ($90,000 rent plus $2,160,000 option price) and are treated as rent to Y (less a reasonable estimate for the residual value of the property) and taxable as such. Assuming a reasonable estimate of the residual value is zero, the full $2,250,000 will be treated as rent, and under §5c.168(f)(8)–7(d), such amount is deductible by X and includible in Y's income ratably over the term of the lease, *i.e.*, at a rate of $250,000 per year ($2,250,000 divided by 9).

Example (2). The facts are the same as in example (1) except that under the terms of the lease X is obligated to make rental payments of $100,000 for each of the first 5 years of the lease and $300,000 for each of the 4 remaining years under the lease. Further, X has an option to purchase the equipment for $1.00 at the end of the lease term. Pursuant to §5c.168(f)(8)–7(d), X's aggregate rental payments are deductible by X and are includible in Y's income ratably over the term of the lease. Thus, the annual rental payments are deemed to be $188,000 per year ($1,700,000 divided by 9).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981]

§5c.168(f)(8)–8 Loss of section 168(f)(8) protection; recapture.

(a) *In general.* Upon the occurrence of an event that causes an agreement to cease to be characterized as a lease under section 168(f)(8), the characterization of the lessor and lessee shall be determined without regard to section 168(f)(8).

(b) *Events which cause an agreement to cease to be characterized as a lease.* A disqualifying event shall cause an agreement to cease to be treated as a lease under section 168(f)(8) as of the date of the disqualifying event. A disqualifying event shall include the following:

(1) The lessor sells or assigns its interest in the lease or in the qualified leased property in a taxable transaction.

(2) The failure by the lessor to file a copy of the information return (or applicable statement) with its income tax return as required in §5c.168(f) (8)–2 (a)(3)(iii).

(3) The lessee (or any transferee of the lessee's interest) sells or assigns its

interest in the lease or in the qualified leased property in a transaction not described in § 5c.168(f)(8)–2(a)(6) and the transferee fails to execute, within the prescribed time, the consent described in § 5c.168(f)(8)–2(a)(5), or either the lessor or the transferee fail to file statements with their income tax returns as required by that paragraph.

(4) The property ceases to be section 38 property as defined in § 1.48–1 in the hands of the lessor or lessee, for example, due to its conversion to personal use or to use predominantly outside the United States, or to use by a lessee exempt from Federal income taxation.

(5) The lessor ceases to be a qualified lessor by becoming an electing small business corporation or a personal holding company (within the meaning of section 542(a)).

(6) The minimum investment of the lessor becomes less than 10 percent of the adjusted basis of the qualified leased property as described in section 168(f)(8)(B)(ii) and § 5c.168(f)(8)–4.

(7) The lease terminates.

(8) The property becomes subject to more than one lease for which an election is made under section 168(f)(8).

(9) Retirements and casualties. [Reserved]

(10) The property is transferred in a bankruptcy or similar proceeding and the lessor fails either to furnish the appropriate notification or to file a statement with its income tax return as required by § 5c.168(f)(8)–2(a)(6).

(11) The property is transferred in a bankruptcy or similar proceeding and not all lenders with perfected and timely interests in the property specifically exclude or release the Federal income tax ownership of the property as required under § 5c.168(f)(8)–2(a)(6)(iii.)

(12) The property is transferred subsequent to a bankruptcy or similar proceeding and the lessor fails to furnish notice to the transferee prior to the transfer or fails to file a statement with its income tax return, and either the lessor fails to secure the transferee's consent or the lessor or the transferee fail to file statements with their returns.

(13) The property is leased under the provisions of section 168(f)(8)(D)(iii) and § 5c.168(f)(8)–6(b)(3) and ceases to be a qualified mass commuting vehicle.

(14) The failure by the lessor to file the required information return described in § 5c.168(f)(8)–2 (a)(3)(ii) by January 31, 1982, unless the lessee files such return by January 31, 1982.

(c) *Recapture.* The required amount of recapture of the investment tax credit and of accelerated cost recovery deductions after a disqualifying event shall be determined under sections 47 and 1245, respectively.

(d) *Consequences of loss of safe harbor protection.* The tax consequences of a disqualifying event depend upon the characterization of the parties without regard to section 168(f)(8). If the lessee would be the owner of the property without regard to section 168(f)(8), the disqualifying event will be deemed to be a sale of the qualified leased property by the lessor to the lessee. The amount realized by the lessor on the sale will include the outstanding amount (if any) of the lessor's debt on the property plus the sum of any other consideration received by the lessor. A disposition that results from a disqualifying event shall not be treated as an installment sale under section 453.

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

Example (1). M Corp. and N Corp. enter into a sale and leaseback transaction in which the leaseback agreement is characterized as a lease under section 168(f)(8) and M is treated as the lessor. In the second year of the lease, M becomes an electing small business corporation under subchapter S. The agreement ceases to be treated as a lease under section 168(f)(8) as of the date of the subchapter S election. Without respect to section 168(f)(8), N would be considered the owner of the property. The disqualification of M will be treated as a sale of the qualified leased property from M to N for the amount of the purchase money debt on the property then outstanding. M will realize gain or loss, depending upon its basis, with applicable investment tax credit and section 1245 recapture. N will acquire the property with a basis equal to the amount of the outstanding obligation. The property will not be used section 38 property to N under § 1.48–3(a)(2).

Example (2). Q Corp. (as lessor) and P Corp. (as lessee) enter into a lease that is characterized as a lease under section 168(f)(8). The lease has a 6-year term. P has no option to renew the lease or to purchase the property.

At the end of 6 years, if P would be considered the owner of the property without regard to section 168(f)(8), upon the termination of the lease the property will be deemed to be sold by Q to P for the amount of the purchase money debt outstanding with respect to the property.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981; T.D. 7800, 46 FR 63259, Dec. 31, 1981]

§ 5c.168(f)(8)–9 Pass-through leases—transfer of only the investment tax credit to a party other than the ultimate user of the property. [Reserved]

§ 5c.168(f)(8)–10 Leases between related parties. [Reserved]

§ 5c.168(f)(8)–11 Consolidated returns. [Reserved]

§ 5c.442–1 Temporary regulations relating to change of annual accounting period.

(a) *Applicability*. The rules of paragraph (b) of this section apply to a request for a change of annual accounting period if—

(1) The taxpayer requesting the change of annual accounting period is an individual;

(2) The purpose for the change of annual accounting period is to benefit as of the first day of a calendar year from changes in the individual income tax rates that do not apply until the first day of the taxpayer's taxable year because of section 21(d) (relating to inapplicability of section 21 to changes made by the Economic Recovery Tax Act of 1981);

(3) The requested change of annual accounting period is from a fiscal year to a calendar year;

(4) In the case of a principal partner in a partnership formed after April 1, 1954, whose principal partners all change to a calendar year, the partnership changes to a calendar year;

(5) In the case of a shareholder in an electing small business corporation whose shareholders all change to a calendar year, the small business corporation changes to a calendar year; and

(6) The short period involved in the change ends on December 31, 1981 or December 31, 1982.

(b) *Special rules*. In the case of a request for a change of annual accounting period described in paragraph (a) of this section, the following special rules apply:

(1) The substantial business purpose requirement contained in § 1.442–1(b) (relating to change of annual accounting period) does not apply.

(2) If the short period involved in the change ends on December 31, 1981, the application for change of annual accounting period may be filed at any time on or before June 15, 1982.

(3) The taxpayer may obtain approval of a change of annual accounting period in the manner set forth in Rev. Proc. 82–25, 1982–15 I.R.B.

(4) The taxpayer shall disclose on the application for change of accounting period any partnership formed after April 1, 1954 in which the taxpayer is a principal partner and any electing small business corporation in which the taxpayer is a shareholder.

(5) Approval of the change of annual accounting period will be granted without regard to the number of years that have elapsed since the taxpayer's previous change of annual accounting period.

(6) No subsequent change of annual accounting period will be approved if the short period involved in the subsequent change would end fewer than 5 calendar years after the last day of the short period involved in the change of accounting period described in paragraph (a) of this section. If the short period involved in the subsequent change would end more than 5 calendar years after the last day of the short period involved in the change of accounting period described in paragraph (a) of this section, the Commissioner will determine whether to approve such change—

(i) Without regard to the change of annual accounting period described in paragraph (a) of this section; and

(ii) In the case of a change to the fiscal year used by the taxpayer before the change of annual accounting period described in paragraph (a) of this section, without regard to the number of years that have elapsed since the taxpayer previously adopted such fiscal year.

(Sec. 7805, Internal Revenue Code of 1954 (68A Stat. 917 (26 U.S.C. 7805)))

[T.D. 7816, 47 FR 15331, Apr. 9, 1982]

§ 5c.1305–1 Special income averaging rules for taxpayers otherwise required to compute tax in accordance with § 5c.1256–3.

(a) *In general.* If an eligible individual (as defined in section 1303 and the regulations thereunder) is described in the first sentence of § 5c.1256–3(a), chooses the benefits of income averaging and otherwise complies with the special rules under section 1304 and the regulations thereunder, and has averagable income (as defined in section 1302 and the regulations thereunder) in excess of $3,000, then the individual shall compute the tax under section 1301 as provided in this section. The computation under this section shall be in lieu of the computation under § 5c.1256–3.

(b) *Computation of tax.* The individual shall compute the tax under section 1301 as follows:

Step (1). Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for the taxable year which includes June 23, 1981.

Step (2). Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for taxable years beginning in 1982.

Step (3). Compute the percentage of adjusted gross income attributable to all sources except regulated futures contracts subject to section 1256(a) and the regulations thereunder.

Step (4). Compute the percentage of adjusted gross income attributable to regulated futures contracts subject to section 1256(a) and the regulations thereunder. Both the percentage in Step (3) and the percentage in Step (4) are to be rounded to the nearest percent. The sum of both percentages must equal 100 percent.

Step (5). Multiply the result of Step (1) with the result of Step (3).

Step (6). Multiply the result of Step (2) with the result of Step (4).

Step (7). Add the result of Step (5) and the result of Step (6). This is the tax for the individual under section 1301 for the taxable year which includes June 23, 1981.

(c) *Option to defer tax.* If an individual computes the tax under section 1301 as provided in paragraph (a) of this section, the individual may also opt to pay part or all of the deferrrable tax under income averaging (as defined in paragraph (d) of this section) for the taxable year which includes June 23, 1981, in 2 or more, but not more than 5, equal installments in accordance with this section. Such individual may not opt to pay part or all of the deferrable tax in installments under § 5c.1256–3. An individual opting to defer payment must attach a statement to Form 6781 indicating the computation of deferrable tax under income averaging, the number of installments in which the individual opts to pay the deferrable tax under income averaging, and the amount of each such payment.

(d) *Deferrable tax under income averaging.* The deferrable tax under income averaging is the excess of—

(1) The tax for the taxable year which includes June 23, 1981, computed pursuant to paragraph (b) of this section, over

(2) The tax for the taxable year which includes June 23, 1981, computed pursuant to paragraph (b) of this section, except that pre-transitional year gain or loss (as described in § 5c.1256–2(g)) is omitted for purposes of recomputing the percentage in Step (4). As computed under this subparagraph (2), the sum of the percentage in Step (3) and Step (4) will not equal 100 percent.

(e) *Rules of application.* The provisions of § 5c.1256–3 (c), (f), (g), (h), (i), and (j) shall apply in computing the tax and in determining the deferrable tax under income averaging under this section.

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

Example (1). Individual A is a single, calendar year taxpayer with no dependents. A reported the following amounts for the following years on line 34 of Form 1040:

1977—$80,000
1978—$90,000
1979—$100,000
1980—$110,000

A reports the following amounts for the following lines on Form 1040 for 1981:

line 7—$120,000
line 12—$600,000
line 32b—$19,000
line 33—$1,000

The amount on line 12 is computed as follows: $937,500 of gain is attributable to regulated futures contracts subject to section

1256(a). Of that total, 40 percent is short term capital gain ($375,000) and 60 percent is long term capital gain ($562,500). Of the long term capital gain, 40 percent is taxable ($225,000). Therefore, A reports $600,000 on line 12 ($375,000+$225,000).

The result of Step (1) is $464,013.41. The result of Step (2) is $337,051.52. The result of Step (3) is 17 percent. The result of Step (4) is 83 percent. The result of Step (5) is $78,882.28. The result of Step (6) is $279,752.76. The result of Step (7) is $358,635.04. This is A's tax for 1981 under section 1301.

Example (2). The facts are the same as in Example (1), except that $703,125 of the $937,500 gain attributable to regulated futures contracts is pre-transitional year gain or loss (as described in § 5c.1256–2(g)). A's tax for 1981 under section 1301 is $358,635.04. A may opt to pay in installments a maximum of $221,004.68 of the tax due in 1981. If A opts to defer the maximum amount and pay in 5 equal installments, A must pay for 1981 a tax of $181,831.30. Each of the 4 succeeding installments is $44,200.94 plus interest computed in accordance with § 5c.1256–3(g)(3).

(Secs. 1305 and 7805 of the Internal Revenue Code of 1954 (78 Stat. 110, 26 U.S.C. 1305; 68A Stat. 917, 26 U.S.C. 7805); secs. 508(c) and 509 of the Economic Recovery Tax Act of 1981 (95 Stat. 333–335))

[T.D. 7826, 47 FR 38692, Sept. 2, 1982]

PART 5e—TEMPORARY INCOME TAX REGULATIONS, TRAVEL EXPENSES OF MEMBERS OF CONGRESS

AUTHORITY: Secs. 280A(f)(4)(B) and 7805 of the Internal Revenue Code of 1954 (95 Stat. 1641, 26 U.S.C. 7805; 68A Stat. 917, 26 U.S.C. 7805).

§ 5e.274–8 Travel expenses of Members of Congress.

(a) *In general.* Members of Congress (including any Delegate and Resident Commissioner) who are away from home within the meaning of section 162 (a), in the Washington, DC area, may elect in accordance with paragraph (f) of this section to deduct an amount described in paragraph (c) of this section as living expenses, without substantiation. A Member who elects under this section may not deduct any amount for the living expenses described in paragraph (b). A Member who does not make an election under this section must substantiate his expenses for living in Washington, DC in accordance with section 274 and § 1.274–5.

(b) *Living expenses covered.* The amount allowed to be deducted without substantiation, pursuant to this section, for costs incurred for living in the Washington, DC area represents amounts expended for meals, lodging, and other incidental expenses. Meals include the actual cost of the food and expenses incident to the preparation and serving thereof. Lodging includes amounts paid for rent, care of premises, utilities, insurance and depreciation of household furnishings owned by the Member. In the case of a Member who lives in a residence owned by him in the Washington, DC area, the cost of lodging also includes depreciation on such residence. Other incidental expenses include laundry, cleaning, and local transportation. Local transportation includes travel within a 50 mile radius of Washington, DC, whether by private automobile, taxicab or other transportation for hire. Interest and taxes on personal property will not be considered expenses to be included within this paragraph.

(c)(1) *Amounts allowed without substantiation.* The amount that may be deducted pursuant to section 162 and these regulations is an amount equal to the product of the number of Congressional days in the taxable year, multiplied by the designated amount. The designated amount is—

(i) In the case of a Member who deducts interest and taxes attributable to the ownership of a personal residence in the Washington, DC area, two-thirds of the maximum amount of actual subsistence for Washington, DC payable pursuant to 5 U.S.C. 5702(c), or

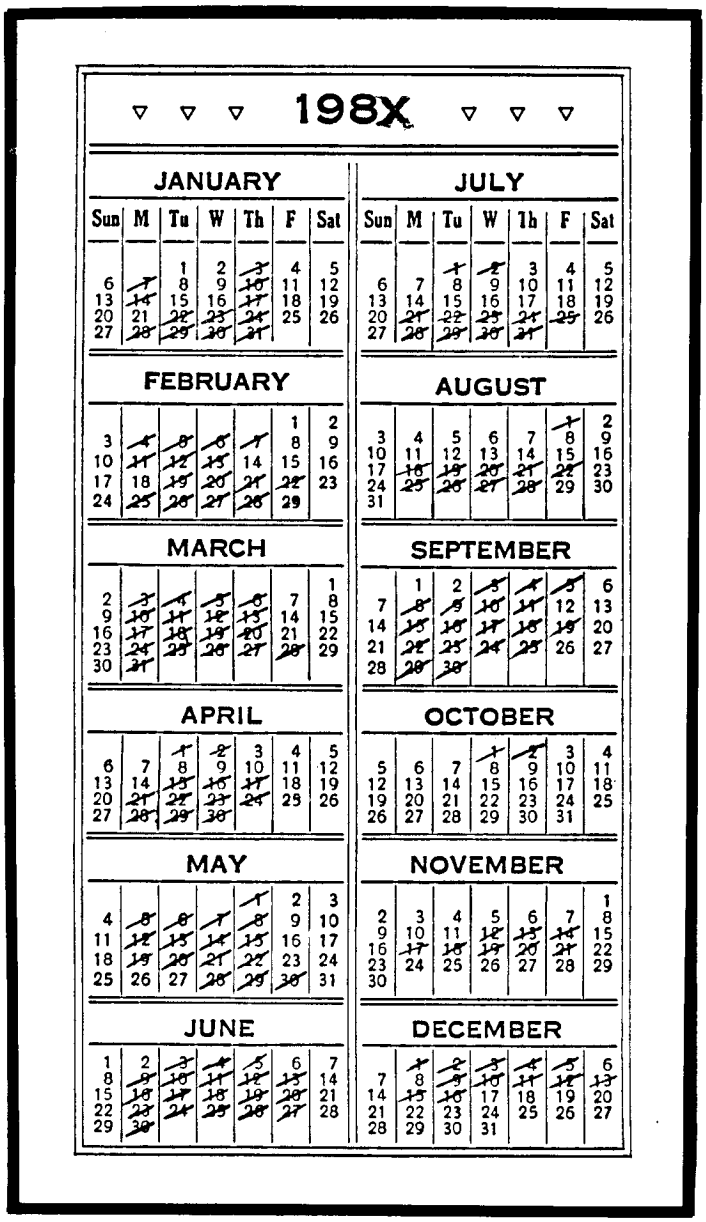
(ii) In the case of a Member not described in paragraph (c)(1)(i), the maximum amount of actual subsistence for Washington, DC payable pursuant to 5 U.S.C. 5702(c).

A Member who incurs interest and taxes on his residence in the Washington, DC area may forego the deduction of such amounts and use the designated amount prescribed by paragraph (c)(1)(ii).

(2) If a Member, who lives in a residence owned by him in the Washington, DC area, chooses to deduct amounts prescribed in paragraph (c)(1) of this

section, the Member must treat as an adjustment to the basis of such residence an amount equal to 20 percent of the maximum amount of actual subsistence multiplied by the number of Congressional days. Such adjustments will be considered a proper adjustment for exhaustion, wear, and tear under this subtitle.

(d) *Congressional days.* The number of Congressional days with respect to a Member is the number of days in the taxable year less the number of days in periods in which the Member's Congressional chamber was not in session for 5 consecutive days or more (including Saturday and Sunday). The number of days with respect to a Member is determined without regard to whether or not the Member was in the Washington, DC area on such days.



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			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	31	

NOVEMBER						
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30						

DECEMBER						
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

(e) *Other deductible amounts.* This section does not preclude the deduction of otherwise allowable expenses for travel fares (other than local travel in the Washington, DC), long distance telephone and telegraph, and travel expenses incurred other than in the Washington, DC area. However, such

expenses are subject to the substantiation requirements of section 274.

(f) *Election.* To elect to deduct the amounts prescribed by this section, a Member must attach to his return for the taxable year a statement indicating, (1) that the deduction for travel expenses while living in the Washington, DC area are computed pursuant to § 5e.274–8, and (2) whether a separate deduction is being taken for interest and taxes paid or incurred with respect to the personal residence of the Member if in the Washington, DC area.

(g) *Effective date.* This section is effective for taxable year beginning after December 31, 1980.

(h) *Examples.* The following examples are based on a calendar from a Final Edition of the Calendar of the United States, House of Representatives and History of Legislation. The marked days indicate days the House of Representatives was in session.

Example 1—In determining the number of Congressional days for 198X for which the designated amount may be computed, the number of days in such year is reduced by 125 days determined as follows:

	Days
Feb. 14–18	5
Apr. 3–14	12
May 23–27	5
July 3–20	18
Aug. 2–17	16
Aug. 29–Sept. 2	5
Oct. 3–Nov. 11	40
Nov. 22–Nov. 30	9
Dec. 17–Dec. 31	15
Total	125

Thus for 198X (a leap year) a typical Member of the House of Representatives will have 241 (366 − 125) Congressional days.

Example 2—On August 1, Z a calendar year taxpayer is elected to the Congress to fill the unexpired term of Member Y. In determining the number of Congressional days, Z may only consider the number of days during the year for which he was a Member of Congress. For Z the number of Congressional days is 68.

Example 3—Member X, a calendar year taxpayer, owns his own home in Washington, DC, where he lives with his family. While in Washington, DC, Member X is away from home within the meaning of section 162(a). X maintains no records attributable to his expenses in Washington, DC X has been a Member of Congress for the entire year. The maximum amount of subsistence for Washington, DC for 198X is $75. X may deduct for 198X $18,075 (241 days×$75) attributable to expenses while away from home in Washington, DC. Even if X maintained records as to living expenses in Washington, DC, X may choose to deduct $18,075 as the total amount attributable to living expenses in Washington, DC. If X deducts $18,075 X may not deduct any interest and taxes under section 163 or 164 attributable to the residence in Washington, DC.

Example 4—Member C, a calendar year taxpayer owns his own home in Washington, DC, where he lives with his family. While in Washington, DC. Member C is away from home within the meaning of section 162(a). C can establish that he paid $12,000 as interest on a mortgage and $3,000 in local real estate taxes. C has been a Member of Congress for the entire year. C may choose to deduct $12,050 (241 days×[⅔×$75]) attributable to expenses in Washington, DC. Further, C may deduct under sections 163 and 164 $12,000 of interest and $3,000 of taxes respectively.

Example 5—Assume the same facts as in Example (4). In addition, on March 15, 16, and 17, Member C travels to New York City to deliver a speech for which he receives an honorarium which he includes in income. C receives no additional amounts for travel reimbursement. While in New York City C incurs $350 for 3 nights lodging at a hotel and $150 for meals. In addition to the amounts deductible pursuant to this section, C may deduct the $500 as a travel expenses. Such deduction is subject to the substantiation rules of section 274.

Example 6—Assume the same facts as example (5). Member C receives, in addition to the honorarium, $600 reimbursement for travel expenses. C must include the $600 in income and may deduct the travel expenses he incurred.

[T.D. 7802, 47 FR 2987, Jan. 21, 1982; 47 FR 4680, Feb. 2, 1982]

PART 5f—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Sec.

5f.103–1 Obligations issued after December 31, 1982, required to be in registered form.
5f.103–2 Public approval of industrial development bonds.
5f.103–3 Information reporting requirements for certain bonds.
5f.163–1 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.
5f.168(f)(8)–1 Questions and answers concerning transitional rules and related matters regarding certain safe harbor leases.
5f.442–1 Temporary regulations relating to change of annual accounting period.

5f.6045–1 Returns of information of brokers and barter exchanges.

AUTHORITY: 26 U.S.C. 7805. Secs. 5f.103–1 and 5f.163–1 also issued under 26 U.S.C. 103(j), 26 U.S.C. 163(f), and 96 Stat. 595. Sec. 5f.6045–1 also issued under 26 U.S.C. 6045.

§ 5f.103–1 Obligations issued after December 31, 1982, required to be in registered form.

(a) *Registration; general rule.* Interest on a registration-required obligation (as defined in paragraph (b) of this section) shall not be exempt from tax notwithstanding section 103 (a) or any other provision of law, exclusive of any treaty obligation of the United States, unless the obligation is issued in registered form (as defined in paragraph (c) of this section).

(b) *Registration-required obligation.* For purposes of this section, the term ''registration-required obligation'' means any obligation except any one of the following:

(1) An obligation not of a type offered to the public. The determination as to whether an obligation is not of a type offered to the public shall be based on whether similar obligations are in fact publicly offered or traded.

(2) An obligation that has a maturity at the date of issue of not more than 1 year.

(3) An obligation issued before January 1, 1983. An obligation first issued before January 1, 1983, shall not be considered to have been issued on or after that date merely as a result of the existence of a right on the part of the holder of such obligation to convert the obligation from registered form into bearer form, or as a result of the exercise of such a right.

(4) An obligation described in § 5f.163–1 (c) (relating to certain obligations issued to foreign persons).

(c) *Registered form*—(1) *General rule.* An obligation issued after January 20, 1987, pursuant to a binding contract entered into after January 20, 1987, is in registered form if—

(i) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder,

(ii) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) (as described in paragraph (c)(2) of this section), or

(iii) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both of the methods described in subdivisions (i) and (ii).

(2) *Special rule for registration of a book entry obligation.* An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation.

(d) *Effective date.* The provisions of this section shall apply to obligations issued after December 31, 1982, unless issued on an exercise of a warrant for the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982.

(e) *Special rules.* The following special rules apply to obligations issued after January 20, 1987, pursuant to a binding contract entered into after January 20, 1987.

(1) An obligation that is not in registered form under paragraph (c) of this section is considered to be in bearer form.

(2) An obligation is not considered to be in registered form as of a particular time if it can be transferred at that time or at any time until its maturity by any means not described in paragraph (c) of this section.

(3) An obligation that as of a particular time is not considered to be in registered form by virtue of subparagraph (2) of this paragraph (e) and that, during a period beginning with a later time and ending with the maturity of the obligation, can be transferred only by a means described in paragraph (c) of this section, is considered to be in

registered form at all times during such period.

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

Example (1). Municipality X publicly offers its general debt obligations to United States persons. The obligations have a maturity at issue exceeding 1 year. The obligations are registration-required obligations under § 5f.103–1(b). When individual A buys an obligation, X issues an obligation in A's name evidencing A's ownership of the principal and interest under the obligation. A can transfer the obligation only by surrendering the obligation to X and by X issuing a new instrument to the new holder. The obligation is issued in registered form.

Example (2). Municipality Y issues a single obligation on January 4, 1983 to Bank M provided that (i) Bank M will not at any time transfer any interest in the obligation to any person unless the transfer is recorded on Municipality Y's records (except by means of a transfer permitted in (ii) of this example) and (ii) interests in the obligation that are sold by Bank M (and any persons who acquire interests from M) will be reflected in book entries. C, an individual, buys an interest in Y's obligation from Bank M. Bank M receives the interest or principal payments with respect to C's interest in the obligation as agent for C. Bank M records interests in the Municipality Y obligation as agent of Municipality Y. Any transfer of C's interest must be reflected in a book entry in accordance with Bank M's agreement with Municipality Y. Since C's interest can only be transferred through a book entry system maintained by the issuer (or its agent), the obligation is considered issued in registered form. Interest received by C is excludable from gross income under section 103(a).

Example (3). Municipality Z wishes to sell its debt obligations having a maturity in excess of 1 year. The obligations are sold to Banks N, O, and P, all of which are located in Municipality Z. By their terms the obligations are freely transferable, although each of the banks has stated that it acquired the obligations for purposes of investment and not for resale. Obligations similar to the obligations sold by Municipality Z are traded in the market for municipal securities. The obligations issued by Municipality Z are of a type offered to the public and are therefore registration-required under § 5f.103–1 (b).

Example (4). Corporation A issues an obligation that is registered with the corporation as to both principal and any stated interest. Transfer may be effected by the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder. The obligation can be converted into a form in which the right to the principal of, or stated interest on, the obligation may be effected by physical transfer of the obligation. Under § 5f.103–1 (c) and (e), the obligation is not considered to be in registered form and is considered to be in bearer form.

Example (5). Corporation B issues its obligations in a public offering in bearer definitive form. Beginning at X months after the issuance of the obligations, a purchaser (either the original purchaser or a purchaser in the secondary market) may deliver the definitive bond in bearer form to the issuer in exchange for a registration receipt evidencing a book entry record of the ownership of the obligation. The issuer maintains the book entry system. The purchaser identified in the book entry as the owner of record has the right to receive a definitive bearer obligation at any time. Under § 5f.103–1 (c) and (e), the obligation is not considered to be issued in registered form and is considered to be issued in bearer form. All purchasers of the obligation are considered to hold an obligation in bearer form.

Example (6). Corporation C issues obligations in bearer form. A foreign person purchases a definitive bearer obligation and then sells it to a United States person. At the time of the sale, the United States person delivers the bearer obligation to Corporation C and receives an obligation that is identical except that the obligation is registered as to both principal and any stated interest with the issuer or its agent and may be transferred at all times until its maturity only through a means described in § 5f.103–1(c). Under § 5f.103–1(e), the obligation is considered to be in registered form from the time it is delivered to Corporation C until its maturity.

(g) *Cross-references.* See section 103A(j)(1) for the registration requirement of certain mortgage subsidy bonds issued after December 31, 1981, and § 6a.103A–1(a)(5) for the definition of registered form for such obligations issued after December 31, 1981, and on or before December 31, 1982. See also section 103(h) (requiring registration of certain energy bonds issued on or after October 18, 1979).

[T.D. 7852, 47 FR 51361, Nov. 15, 1982, as amended by T.D. 8111, 51 FR 15463, Dec. 19, 1986]

§ 5f.103–2 Public approval of industrial development bonds.

(a) *General rule.* An industrial development bond (within the meaning of § 1.103–7(b)(1) issued after December 31, 1982, shall be treated as an obligation not described in section 103(a) unless it

is issued as part of an issue which satisfies the public approval requirement of section 103(k) and paragraph (c) of this section or is described in the exceptions set forth in paragraph (b) of this section.

(b) *Exceptions*—(1) *No extension of maturity.* Paragraph (a) of this section does not apply to a refunding obligation if—

(i) It refunds an obligation which was approved under section 103(k) and this section (or which is treated as approved pursuant to paragraph (f) of this section), and

(ii) It has a maturity date which is not later than the maturity date of the obligation to be refunded.

(2) *Refunding of pre-July 1, 1982, obligation.* Paragraph (a) of this section does not apply to an obligation issued solely to refund an obligation which—

(i) Was issued before July 1, 1982, and

(ii) Has a term which does not exceed 3 years.

The term of an obligation is determined without regard to whether it is a refunding obligation. With respect to the refunding of an issue also containing obligations with terms which exceed 3 years, paragraph (b)(2) applies only if the refunding issue proceeds are used solely to refund obligations with terms not exceeding 3 years and to pay reasonable incidental costs of the refunding (*e.g.,* legal and accounting fees, printing costs, and rating fees) attributable thereto. Paragraph (b)(2) applies only to issues issued after December 31, 1982, the proceeds of which are used to refund issues issued prior to July 1, 1982. Thus, subsequent refundings of such refunding issues must satisfy the public approval requirement of section 103(k) and paragraph (c) of this section.

(c) *Public approval requirement*—(1) *In general.* An issue is publicly approved if prior to the date of issue the governmental unit(s) described in subparagraphs (2) and (3) this paragraph (c) approve the issue, in the manner described in paragraph (d) of this section. See paragraph (f) for rules pertaining to determining the scope of an approval and paragraph (g)(1) for the definition of ''governmental unit''.

(2) *Issuer approval.* The governmental unit (i) which will issue the obligations or (ii) on behalf of which the issue is to be issued must approve the issue (''issuer approval''). If the issuer is not a governmental unit, the governmental unit on behalf of which the issuer acts shall be determined in a manner consistent with determinations under § 1.103–1, and such unit must approve the issue. However, in the case of an issuer which issues obligations on behalf of more than one governmental unit (*e.g.,* an authority which acts for two counties), any one of such units may give the issuer approval required by this paragraph (c)(2).

(3) *Host approval.* Each governmental unit the geographic jurisdiction (as defined in paragraph (g)(4)) of which contains the site of a facility to be financed by the issue must approve the issue (''host approval''). However, if the entire site of a facility to be financed by the issue is within the geographic jurisdiction of more than one governmental unit within a State (counting the State as a governmental unit within such State), then any one of such units may provide host approval for the issue with respect to that facility. For purposes of this paragraph (c)(3), if property to be financed by the issue is located within two or more governmental units but not entirely within either of such units, each portion of the property which is located entirely within the smallest respective governmental units may be treated as a separate facility. The issuer approval (as described in paragraph (c)(2)) may be treated as a host approval if the governmental unit giving the issuer approval is also a governmental unit described in this paragraph (c)(3). See paragraph (e)(2) with respect to host approval by a governmental unit with no applicable elected representative.

(d) *Method of public approval.* For purposes of this section, an issue is approved by a governmental unit only if—

(1) An applicable elected representative (as defined in paragraph (e)) of such unit approves the issue following a public hearing (as defined in paragraph (g)(2)) held in a location which, under the facts and circumstances, is convenient for residents of the unit, and for which there was reasonable public notice (as defined in paragraph (g)(3)), or

(2) A referendum of the voters of the unit (as defined in paragraph (g)(5)) approves the issue.

An approval may satisfy the requirements of this section without regard to the authority under State or local law for the acts constituting such approval. The location of hearing will be presumed convenient for residents of the unit if it is located in the approving governmental unit's capital or seat of government. If more than one governmental unit is required to provide a public hearing, such hearings may be combined as long as the combined hearing is a joint undertaking that provides all of the residents of the participating governmental units (*i.e.*, those relying on such hearing as an element of public approval) a reasonable opportunity to be heard. The location of any combined hearing is presumed to provide a reasonable opportunity to be heard provided it is no farther than 100 miles from the seat of government of each participating governmental unit beyond whose geographic jurisdiction the hearing is conducted.

(e) *Applicable elected representative*—(1) *In general.* The applicable elected representative of a governmental unit means—

(i) Its elected legislative body,

(ii) Its chief elected executive officer,

(iii) In the case of a State, the chief elected legal officer of the State's executive branch of government, or

(iv) Any official elected by the voters of the unit and designated for purposes of this section by the unit's chief elected executive officer or by State or local law to approve issues for the unit.

For purposes of subdivisions (ii), (iii), and (iv) of this paragraph (e)(1), an official shall be considered elected by the voters of the unit only if he is popularly elected at-large by the voters of the governmental unit. If an official popularly elected at-large by the voters of a governmental unit is appointed or selected pursuant to State or local law to be the chief executive officer of the unit, such official is deemed to be an elected chief executive officer for purposes of this section but for no longer than his tenure as an official elected at-large. In the case of a bicameral legislature which is popularly elected, both chambers together constitute an applicable elected representative, but neither chamber does independently, unless so designated under paragraph (e)(1)(iv). If multiple elected legislative bodies of a governmental unit have independent legislative authority, however, the body with the more specific authority relating to the issue is the only legislative body described in paragraph (e)(1)(i) of this section. See paragraph (h), Example (7) of this section.

(2) *Governmental unit with no applicable elected representative.* (i) The applicable elected representatives of a governmental unit with no representative (but for this paragraph (e)(2) and section 103(k)(2)(E)(ii)) are deemed to be those of the next higher governmental unit (with an applicable elected representative) from which the governmental unit derives its authority. For purposes of this subparagraph (2), a governmental unit derives its authority from another unit which—

(A) Enacts a specific law (*e.g.*, a provision in a State constitution, charter or statute) by or under which the governmental unit is created,

(B) Otherwise empowers or approves the creation of the governmental unit, or

(C) Appoints members to the governing body of the governmental unit.

In the case of a governmental unit with no applicable elected representative (but for this paragraph (e)(2)), any unit described in subdivision (A), (B), or (C) or this paragraph (e)(2)(i) may be treated as the next higher unit, without regard to the relative status of all of such units under State law.

(ii) In the case of a host approval (as required under paragraph (c)(3) of this section), a unit may be treated as the next higher unit, only if—

(A) The facility is located within its geographic jurisdiction, and

(B) Eligible individuals, if any, residing at the site of the facility are entitled to vote for the applicable elected representative of that unit (as determined under this paragraph (e)).

(3) *On behalf of issuers.* In the case of an issuer which is not a governmental unit but which issues bonds on behalf of a governmental unit, the applicable elected representative is any applicable elected representative of the unit on behalf of which the bonds are issued. If

the unit on behalf of which the bonds are issued has no applicable elected representative (but for paragraph (e)(2) of this section), the applicable elected representative of the governmental unit is determined in the manner described in paragraph (e)(2).

(f) *Scope of approval*—(1) *In general.* Public approval is required by section 103(k) and this section for issues of industrial development bonds, except as otherwise provided in paragraphs (a) and (b) of this section. An issue is treated as approved if the governmental units (described in paragraph (c) of this section in relation to the issue) have approved either—

(i) The issue (by approving each facility to be financed), not more than one year before the date of issue, or

(ii) A plan of financing for each facility financed by the issue pursuant to which the issue in question is timely issued (as required in paragraph (f)(3) of this section).

In either case, the scope of the approval is determined by the information, as specified in paragraph (f)(2), contained in the notice of hearing (when required) and the approval.

(2) *Information required.* A facility is within the scope of an approval if the notice of hearing (when required) and the approval contain—

(i) A general, functional description of the type and use of the facility to be financed (*e.g.*, ''a 10,000 square foot machine shop and hardware manufacturing plant'', ''400-room airport hotel building'', ''dock facility for supertankers'', ''convention center auditorium and sports arena with 25,000 seating capacity'', ''air and water pollution control facilities for oil refinery''),

(ii) The maximum aggregate face amount of obligations to be issued with respect to the facility,

(iii) The initial owner, operator, or manager of the facility,

(iv) The prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.

An approval is valid for purposes of this section with respect to any issue used to provide publicly approved facilities, notwithstanding insubstantial deviations with respect to the maximum aggregate face amount of the bonds issued under the approval for the facility, the name of its initial owner, manager, or operator, or the type or location of the facility from that described in the approval. An approval or notice of public hearing will not be considered to be adequate if any of the items in subdivisions (i) through (iv) of this subparagraph (2), with respect to the facility to be financed, are unknown on the date of the approval or the date of the public notice.

(3) *Timely issuance pursuant to a plan of financing.* An issue is timely issued pursuant to a plan of financing for a facility if—

(i) The issue is issued no later than 3 years after the first issue pursuant to the plan, and

(ii) The first such issue in whole or in part issued pursuant to the plan was issued no later than 1 year after the date of approval.

(4) *Facility—definition.* For purposes of this paragraph (f), the term ''facility'' includes a tract or adjoining tracts of land, the improvements thereon and any personal property used in connection with such real property. Separate tracts of land (including improvements and connected personal property) may be treated as one facility only if they are used in an integrated operation.

(g) *Definitions.* For purposes of this section—(1) *Governmental unit.* Governmental unit has the same meaning as in § 1.103–1. Thus, a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof. The term ''political subdivision'' denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

(2) *Public hearing.* Public hearing means a forum providing a reasonable opportunity for interested individuals to express their views, both orally and in writing, on the proposed issue of bonds and the location and nature of a proposed facility to be financed. In general, a governmental unit may select its own procedure for the hearing, provided that interested individuals

have a reasonable opportunity to express their views. Thus, it may impose reasonable requirements on persons who wish to participate in the hearing, such as a requirement that persons desiring to speak at the hearing so request in writing at least 24 hours before the hearing or that they limit their oral remarks to 10 minutes. For purposes of this public hearing requirement, it is not necessary, for example, that the applicable elected representative who will approve the bonds be present at the hearing, that a report on the hearing be submitted to that official, or that State administrative procedural requirements for public hearings in general be observed. However, compliance with such State procedural requirements (except those at variance with a specific requirement set forth in this section) will generally assure that the hearing satisfies the requirements of this section. The hearing may be conducted by any individual appointed or employed to perform such function by the governmental unit or its agencies, or by the issuer (if on behalf of issuer). Thus, for example, for bonds to be issued by an authority that acts on behalf of a county, the hearing may be conducted by the authority, the county, or an appointee or employee of either.

(3) *Reasonable public notice.* Reasonable public notice means published notice which is reasonably designed to inform residents of the affected governmental units, including residents of the issuing unit and the governmental unit where a facility is to be located, of the proposed issue. The notice must state the time and place for the hearing and contain the information contained in paragraph (f)(2) of this section. Notice is presumed reasonable if published no fewer than 14 days before the hearing. Except in the locality of the facility, publication is presumed to be reasonably designed to inform residents of the approving governmental unit if given in the same manner and same locations as required of the approving governmental unit for any other purposes for which applicable State or local law specifies a notice of public hearing requirement (including laws relating to notice of public meetings of the governmental unit). Notice is presumed reasonably designed to inform affected residents in the locality of the facility only if published in one or more newspapers of general circulation available to residents of that locality or if announced by radio or television broadcast to those residents.

(4) *Geographic jurisdiction.* Geographic jurisdiction is the area encompassed by the boundaries prescribed by State or local law for a governmental unit or, if there are no such boundaries, the area in which a unit may exercise such sovereign powers that make that unit a governmental unit for purposes of § 1.103–1 and this section.

(5) *Voter referendum.* A voter referendum is a vote by the voters of the affected governmental unit conducted in the manner and at such a time as voter referenda on matters relating to governmental spending or bond issuances by the governmental unit under applicable State and local law.

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

Example (1). State X proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within the geographic jurisdiction of City Y (which is located in State X). Under the provisions of paragraph (c), only State X must approve the issue because State X is the issuer and the facility is to be located entirely within the State's geographic jurisdiction. Its applicable elected representative must approve the issue after the public notice and public hearing requirements are satisfied.

Example (2). (i) Industrial Development Authority X proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within the geographic jurisdiction of City Y (which is located in State Z). Authority X acts on behalf of State Z. Under the provisions of paragraph (c), only State Z must approve the issue because State Z is the governmental unit on behalf of which Authority X, the issuer, is acting and the facility is to be located entirely within its geographic jurisdiction.

(ii) State Z has a governor, an elected bicameral legislature and an appointed attorney general who is the chief legal officer of State Z. Under the laws of State Z, the attorney general must approve any issue of industrial development bonds. The approval by the attorney general is not a sufficient approval under this section, since the attorney

general is not an applicable elected representative within the meaning of this section. Under the provisions of paragraphs (d) and (e), either the governor, both chambers of the legislature or any popularly elected official of the State who is designated for this purpose by the governor or by State law must approve the issue after the public notice and public hearing requirements are satisfied.

Example (3). (i) County Y, a county in State X, proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within its jurisdiction. Under the provisions of paragraph (c), only County Y must approve the issue because County Y is the issuer and the facility is to be located entirely within the geographic jurisdiction of County Y.

(ii) County Y has no elected officials or legislature. County Y derives its authority from State X which is the next higher governmental unit with an applicable elected representative. The laws of State X designate the attorney general, who is an official of State X elected at-large, as the official who must approve any issue of industrial development bonds for the State. Under this section, State X's attorney general is an applicable elected representative who may approve the issue after the public notice and public hearing requirements are satisfied.

Example (4). (i) City X, a city located in County Y and State Z, proposes to issue an industrial development bond, the proceeds of which are to finance a facility located entirely within the geographic jurisdiction of City X. Under the provisions of paragraph (c), only City X must approve the issue because it is the issuer and the facility is to be located entirely within the geographic jurisdiction of City X.

(ii) Mayor A, the chief elected executive officer of City X, has designated, for purposes of this section, Deputy Mayor B, an official of City X elected at-large, to approve industrial development bond issues for the city. Under the provisions of paragraph (e), Deputy Mayor B may approve the issue, since he is an applicable elected representative, after the public notice and public hearing requirements are satisfied.

Example (5). (i) County M proposes to issue an industrial development bond to finance a project located partly within the geographic jurisdiction of County M and partly within the geographic jurisdiction of County N. Both counties are located in State X. The part of the project in County N is also located partly within the geographic jurisdiction of City O and partly within the geographic jurisdiction of City P. Under the provisions of paragraph (c)(2), County M must give issuer approval. Additionally, under the provisions of paragraph (c)(3), either State X, County N, or both Cities O and P, must give host approval.

(ii) Counties M and N will approve the issue, but neither has any officials who are elected at-large by the voters of the respective governmental units. Both governmental units derive their authority from State X which is the next higher governmental unit with an applicable elected representative. Under the provisions of paragraph (e), an applicable elected representative of State X must approve the issue for Counties M and N after the public notice and public hearing requirements are satisfied.

Example (6). (i) County M proposes to issue an industrial development bond to finance two facilities. One facility is located entirely within the geographic jurisdiction of County M and the second facility is located partly within the geographic jurisdiction of County M and partly within the geographic jurisdiction of County N. The second facility is also located within the geographic jurisdictions of Cities O and P, which cities are located within the geographic jurisdiction of County N. Under the provisions of paragraph (c)(2), County M must give issuer approval. Additionally, under the provisions of paragraph (c)(3), either State X, County N, or both Cities O and P, must give host approval.

(ii) Counties M and N will approve the issue. Each has a chief elected executive officer. Under the provisions of paragraphs (d) and (e), the chief elected executive officer of each county may approve the issue, after the public notice and public hearing requirements are satisfied.

Example (7). (i) State X proposes to issue an industrial development bond to finance a facility located partly within the geographic jurisdiction of State X and partly within the geographic jurisdiction of State Y. That portion of the facility located in State Y is located entirely within the geographic jurisdiction of City Z. State X must give issuer approval. Additionally, either State Y or City Z must give host approval as that part of the facility to be located outside State X will be entirely within the geographic jurisdiction of each unit.

(ii) Under the provisions of paragraphs (d) and (e), the governor of State X may approve the issue, after the public notice and public hearing requirements are satisfied. City Z (assuming that it give host approval for the bond) has a city council and a school board, both of which are elected legislative bodies with independent jurisdiction. The authority of the school board is limited under State law to matters directly concerning the provision of public education. Under paragraph (e), the school board is not an applicable elected representative of City Z but the city council is an applicable elected representative of City Z. The city council may approve the issue after the public hearing and public notice requirements are satisfied.

Example (8). (i) Public Housing Authority M, a governmental unit, proposes to issue an

industrial development bond to finance several housing projects with known sites located entirely within its geographic jurisdiction. M's geographic jurisdiction is coextensive with the combined geographic jurisdictions of Counties N and O. The projects are separately owned and managed. They are not adjacent to each other. The projects also are located in County N. Under the provisions of paragraph (c), M must give issuer approval.

(ii) M, which has no elected officials or legislature, was created by both Counties N and O pursuant to a special statute of State Q permitting such a joint undertaking. Both Counties N and O have an applicable elected representative. Under the provisions of paragraph (e)(2), either County N, County O, or State Q is deemed to be the next higher governmental unit with an applicable elected representative, and an applicable elected representative from any of these units may give the issuer approval for Authority M. Therefore, either the applicable representative of County N, County O, or State Q can give the issuer approval for Authority M.

(iii) For purposes of the host approval, the issuer approval by M will satisfy the host approval requirement only if the applicable elected representative of County N or State Q gives issuer approval for M. Under the provisions of paragraph (e)(2), the host approval requirement is satisfied only if qualified persons residing at the site of the facility are entitled to vote for the applicable elected representative who gave the approval (*i.e.*, the representative of State Q or County N). However, if the applicable elected representative of O gave issuer approval for Authority M, a separate host approval would be required because the residents of the sites where the projects are located (*i.e.*, County N) could not note for the applicable elected representative of County O.

(iv) Public Housing Authority M conducts a public hearing concerning prospective housing projects following notice thereof published in a newspaper of general circulation in County N. Additionally, M provides notice to the residents of O (which are also within M's jurisdiction) in the manner required for notice of public hearing for other purposes under State Q law. Following the public hearing, the chief elected executive officer of County N approves for Authority M prospective issues for the project. M issues two $7 million issues, one for each project. One issue is issued six months after the date of approval; the second issue is issued thirteen months thereafter. On these facts, only the first issue satisfied the public approval requirement of this section.

[T.D. 7892, 48 FR 21117, May 11, 1983]

§ 5f.103–3 Information reporting requirements for certain bonds.

(a) *General rule.* Under section 103(l), any private purpose bond issued after December 31, 1982 (including any obligation issued thereafter to refund private purpose bonds issued before December 31, 1982) shall be treated as an obligation not described in section 103(a) unless the information reporting requirement (as described in paragraph (c) of this section) is substantially satisfied with respect to the issue of which the bond is a part. For rules concerning bonds issued after December 31, 1986, see § 1.149(e)–1 of this chapter.

(b) *Private purpose bonds.* For purposes of this section, the term ''private purpose bond'' means—

(1) Any industrial development bond (as defined in section 103(b)(2) and § 1.103–7(b)(1)), or

(2) Any obligation which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly—

(i) To finance loans to individuals for educational or related expenses (hereinafter referred to as a ''student loan bond''), or

(ii) By an organization described in section 501(c)(3) which is exempt from taxation by reason of section 501(a) (hereinafter referred to as ''private exempt entity bond'').

The meaning of the terms ''major portion'' and ''directly or indirectly'' shall be the same as under § 1.103–7. Student loan bonds include, but are not limited to, qualified scholarship funding bonds (as defined in section 103(e)).

(c) *Information required.* An obligation satisfies the requirements of section 103(l) and this section only if it is issued as part of an issue with respect to which the issuer, based on information and reasonable expectations determined as of the date of issue, submits on Form 8038 the information required therein, including—

(1) The name, address, and employer identification number of the issuer,

(2) The date of issue (as defined in paragraph (g)(1)),

(3) The face amount of the issue,

(4) The total purchase price of the issue,

(5) The amount allocated to a reasonably required reserve or replacement fund,

(6) The amount of lendable proceeds (as defined in paragraph (g)(4) of this section),

(7) The stated interest rate of each maturity (as defined in paragraph (g)(2) of this section) or, if the interest rate is variable, a description of the method under which the interest rate is computed,

(8) The term (as defined in paragraph (g)(3)) of each maturity,

(9) A general description of the property to be financed by the issue (including property financed by an obligation that will be refunded with the issue proceeds) which includes—

(i) The type of bond issued, that is, a student loan bond, a private exempt entity bond, or an industrial development bond and in the case of an industrial development bond described in section 103(b)(4), the subparagraph of section 103(b)(4) that describes the property, *e.g.*, for a football stadium, that the property is described in section 103(b)(4)(B),

(ii) The recovery classes (as defined in section 168(c)(2)), if applicable, of the various items of financed property and the approximate amount of lendable proceeds attributable thereto,

(iii) The approximate amount of lendable proceeds attributable to land or other property not described in subdivision (ii),

(iv) In the case of obligations described in section 103(b)(6) or private exempt entity bonds, the four-digit Standard Industrial Classification Code of the facilities financed,

(10) If section 103(k) (relating to public approval requirement for industrial development bonds) applies to such issue, the name(s) of the approving governmental unit(s) and of the applicable elected representative(s) (as defined in section 103(k)(2)(E) and § 5f.103–2(e)) or a description of the voter referendum that approved the issue for such unit(s), and

(11) The name, address, and employer identification number of—

(i) Each initial principal user (as defined in paragraph (g)(5) of this section) of any facilities provided with the proceeds of the issue,

(ii) The common parent, if any, of any affiliated group of corporations (as defined in section 1504(a) but determined without regard to the exceptions of section 1504(b)) of which such initial principal user is a member, and

(iii) Any person (not included under paragraph (c)(11)(i)) that is treated as a principal user under section 103(b)(6)(L), but only if the issue is treated as a separate issue under section 103(b)(6)(K).

The information to be supplied must be determined based on information and reasonable expectations as of the date of issue. Therefore, such statement need not be amended to report information learned subsequent to the date of issue. However, if the statement is filed after the date of issue it may reflect such information and the reasonable expectations of the issuer as of that date.

(d) *Additional information.* An issuer may supply the following information—

(1) The average maturity of the issue (as defined in section 103(b)(14)), and

(2) The average reasonably expected economic life (as defined in section 103(b)(14)) of the facility which is financed with the issue.

(e) *Time for filing.* The statement required by section 103(l) and this section shall be filed not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the obligation is issued. It may be filed at any time before such date but must be complete based on facts and reasonable expectations as of the date of issue. The Secretary may grant an extension of time for filing the statement required under section 103(l) and this section if there is reasonable cause for the failure to file such statement in a timely fashion.

(f) *Place for filing.* Form 8038 is to be mailed to the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(g) *Definitions.* For purposes of this section—

(1) The term *date of issue* means the date on which the issuer physically exchanges the first of the obligations which are part of the issue for the underwriter's (or other purchaser's) funds. In the event that amounts are

periodically advanced with respect to an issue, the date of issue is when the first of such obligations under the issue is created and the funds are advanced.

(2) The term *maturity* means those obligations of the issue having both the same maturity date and the same stated interest rate.

(3) The term *term of an issue* means the duration of the period beginning on the date of issue and ending on the latest maturity date of any obligation of the issue without regard to optional redemption dates.

(4) The term *lendable proceeds* means the amount of the original proceeds, net of amounts allocated to a reasonably required reserve or replacement fund. See generally § 1.103–13(b) and § 1.103–14(d) for further definitions.

(5) The term *initial principal user* means each person who as of the date of issue is obligated to use the facility to such an extent that under section 103(b)(6) such person would be treated as a principal user. With respect to organizations described in section 501(c)(3), however, such determination is made without regard to whether such organization is treated as an exempt organization under section 103(b)(3) and § 1.103–7(b)(2).

[T.D. 7892, 48 FR 21120, May 11, 1983, as amended by T.D. 8129, 52 FR 7411, Mar. 11, 1987; T.D. 8425, 57 FR 36003, Aug. 12, 1992]

§ 5f.163–1 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

(a) *Denial of deduction generally.* Interest paid or accrued on a registration-required obligation (as defined in paragraph (b) of this section) shall not be allowed as a deduction under section 163 or any other provision of law unless such obligation is issued in registered form (as defined in § 5f.103–1(c)).

(b) *Registration-required obligation.* For purposes of this section, the term ''registration-required obligation'' means any obligation except any one of the following:

(1) An obligation issued by a natural person.

(2) An obligation not of a type offered to the public. The determination as to whether an obligation is not of a type offered to the public shall be based on whether similar obligations are in fact publicly offered or traded.

(3) An obligation that has a maturity at the date of issue of not more than 1 year.

(4) An obligation issued before January 1, 1983. An obligation first issued before January 1, 1983, shall not be considered to have been issued on or after such date merely as a result of the existence of a right on the part of the holder of such obligation to convert such obligation from registered form into bearer form, or as a result of the exercise of such a right.

(5) An obligation described in subparagraph (1) of paragraph (c) (relating to certain obligations issued to foreign persons).

(c) [Reserved]

(d) *Effective date.* The provisions of this section shall apply to obligations issued after December 31, 1982, unless issued on an exercise of a warrant for the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982.

(e) *Obligations first issued after December 31, 1982, where the right exists for the holder to convert such obligation from registered form into bearer form.* [Reserved]

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

Example (1). All of the shares of Corporation X are owned by two individuals, A and B. X desires to sell all of its assets to Corporation Y, all of the shares of which are owned by individual C. Following the sale, Corporation X will be completely liquidated. As partial consideration for the Corporation X assets, Corporation Y delivers a promissory note to X, secured by a security interest and mortgage on the acquired assets. The note given by Y to X is not of a type offered to the public.

Example (2). Corporation Z has a credit agreement with Bank M pursuant to which Corporation Z may borrow amounts not exceeding $10X upon delivery of Z's note to Bank M. The note Z delivers to M is not of a type offered to the public.

Example (3). Individuals D and E operate a retail business through partnership DE. D wishes to loan partnership DE $5X. DE's note evidencing the loan from D is not of a type offered to the public.

Example (4). Individual F owns one-third of the shares of Corporation W. F makes a cash advance to W. W's note evidencing F's cash advance is not of a type offered to the public.

Example (5). Closely-held Corporation R places its convertible debentures with 30 individuals who are United States persons. The offering is not required to be registered under the Securities Act of 1933. Similar debentures are publicly offfered and traded. The obligations are not considered of a type not offered to the public.

Example (6). In 1980, Corporation V issued its bonds due in 1986 through an offering registered with the Securities and Exchange Commission. Although the bonds were initially issued in registered form, the terms of the bonds permit a holder, at his option, to convert a bond into bearer form at any time prior to maturity. Similarly, a person who holds a bond in bearer form may, at any time, have the bond converted into registered form.

(i) Assume G bought one of Corporation V's bonds upon the original issuance in 1980. In 1983, G requests that V convert the bond into bearer form. Except for the change from registered to bearer form, the terms of the bond are unchanged. The bond held by G is not considered issued after December 31, 1982, under § 5f.163–1(b)(4).

(ii) Assume H buys one of Corporation V's bonds in the secondary market in 1983. The bond H receives is in registered form, but H requests that V convert the obligation into bearer form. There is no other change in the terms of the instrument. The bond held by H is not considered issued after December 31, 1982, under § 5f.163–1(b)(4).

(iii) Assume the same facts as in (ii) except that in 1984 I purchases H's V Corporation bond, which is in bearer form. I requests V to convert the bond into registered form. There is no other change in the terms of the instrument. In 1985, I requests V to convert the bond back into bearer form. Again, there is no other change in the terms of the instrument. The bond purchased by I is not considered issued after December 31, 1982, under § 5f.163–1(b)(4).

Example (7). Corporation U wishes to make a public offering of its debentures to United States persons. U issues a master note to Bank N. The terms of the note require that any person who acquires an interest in the note must have such interest reflected in a book entry. Bank N offers for sale interests in the Corporation U note. Ownership interests in the note are reflected on the books of Bank N. Corporation U's debenture is considered issued in registered form.

Example (8). Issuer S wishes to make a public offering of its debt obligations to United States persons. The obligations will have a maturity in excess of one year. On November 1, 1982, the closing on the debt offering occurs. At the closing, the net cash proceeds of the offering are delivered to S, and S delivers a master note to the underwriter of the offering. On January 2, 1983, S delivers the debt obligations to the purchasers in definitive form and the master note is cancelled. The obligations are not registration-required because they are considered issued before January 1, 1983.

Example (9). In July 1983, Corporation T sells an issue of debt obligations maturing in 1985 to the public in the United States. Three of the obligations of the issue are issued to J in bearer form. The balance of the obligations of the issue are issued in registered form. The terms of the registered and bearer obligations are identical. The obligations issued to J are of a type offered to the public and are registration-required obligations. Since the three obligations are issued in bearer form, T is subject to the tax imposed under section 4701 with respect to the three bearer obligations. In addition, interest paid or accrued on the three bearer obligations is not deductible by T. Moreover, since the issuance of the three bearer obligations is subject to tax under section 4701, J is not prohibited from deducting losses on the obligations under section 165(j) or from treating gain on the obligations as capital gain under section 1232(d). The balance of the obligations in the issue do not give rise to liability for the tax under section 4701, and the deductibility of interest on such obligations is not affected by section 163(f).

Example (10). Broker K acquires a bond issued in 1980 by the United States Treasury through the Bureau of Public Debt. Broker K sells interests in the bond to the public after December 31, 1982. A purchaser may acquire an interest in any interest payment falling due under the bond or an interest in the principal of the bond. The bond is held by Custodian L for the benefit of the persons acquiring these interests. On receipt of interest and principal payments under the bond, Custodian L transfers the amount received to the person whose ownership interest corresponds to the bond component giving rise to the payment. Under section 1232B, each bond component is treated as an obligation issued with original issue discount equal to the excess of the stated redemption price at maturity over the purchase price of the bond component. The interests sold by K are obligations of a type offered to the public. Further, the interests are, in accordance with section 1232B, considered issued after December 31, 1982. Accordingly, the interests are registration-required obligations under § 5f.163–1(b).

[T.D. 7852, 47 FR 51362, Nov. 15, 1982, as amended by T.D. 7965, 49 FR 33235, Aug. 22, 1984]

§ 5f.168(f)(8)–1 Questions and answers concerning transitional rules and related matters regarding certain safe harbor leases.

The following questions and answers concern the transitional rules and related matters regarding certain safe harbor leases under section 208(d) of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97–248) (''TEFRA''):

Q–1: If a lessee, prior to the period beginning after December 31, 1980, and ending before July 2, 1982 (the ''window period''), enters into a binding contract to acquire property and the property is delivered to the lessee during the window period, is the property eligible for the transitional rule provided in section 208(d)(3) of TEFRA which applies the safe harbor leasing rules of section 168(f)(8) of the Internal Revenue Code of 1954 as in effect before the enactment of TEFRA?

A–1: Yes, assuming all other requirements of the TEFRA transitional rules are met. Section 208(d)(3)(A) (i) and (ii) of TEFRA provide alternative tests under which an item of property may constitute ''transitional safe harbor lease property'' for purposes of the transitional rules under the modifications to the safe harbor lease provisions of section 168(f)(8). The tests are:

(i) The lease entered into a binding contract to acquire the property;

(ii) The lessee entered into a binding contract to construct the property;

(iii) The property was acquired by the lessee; or

(iv) Construction of the property was commenced by or for the lessee.

These tests are stated in the alternative, and, accordingly, property may be eligible for pre-TEFRA safe harbor leasing if any one of the tests is satisfied. Thus, if a lessee acquired property during the window period, the property may be eligible for pre-TEFRA safe harbor leasing even though a binding contract to acquire the property was executed before the window period. Similarly, if construction of property commences during the window period, the property may be eligible for pre-TEFRA safe harbor leasing even though a binding contract to construct the property was executed before the window period.

Q–2: How do the transitional rules apply to components of an integrated manufacturing, production, or extraction process, none of which would be considered ''placed in service'' until all of the components are placed in service?

A–2: (i) The transitional rules regarding acquisition, binding contracts, and commencement of construction are applied to each separate item of property which is part of a manufacturing, production, or extraction process. What constitutes a separate item will be determined on a case-by-case basis, taking into account all relevant factors. In general, a discrete component capable of performing a function which is separate from or in addition to the function of other components to which it may be related is a separate item of property; but an item that is integrated into a component which performs a function separate from other components to which it is related is not itself a separate item of property. For example, a bolt or a nut that is used to construct a machine does not constitute a separate item of property. On the other hand, the transitional rules will not be applied to an entire facility as a whole, as was the case under the investment tax credit transition rule of section 50 in *Hawaiian Independent Refinery, Inc. v. United States*, 49 AFTR 2d 675 (Ct. Cl. Tr. Judge 1982), where the taxpayer was held to have constructed a property which consisted of an entire refinery complex. Thus, for example, for purposes of these transitional rules, an oil or gas well, storage tanks, and pipeline located on a lease would not be considered a single item of property. Although each item is related to the production of oil or gas, each is discrete and each is capable of performing a separate function from the other. In addition, in the case of an integrated manufacturing, production, or extraction process, commencement of construction of one item of property within the process would not be considered construction of any other item of property that is part of the process.

(ii) If property qualifies as transitional safe harbor lease property, all direct and indirect costs allocable to the property (except for those described in § 5c.168(f)(8)–6(a)(2)(ii)) and required to be capitalized for Federal income tax purposes will also qualify as transitional safe harbor lease property to the extent such costs are incurred on or before the date on which the property is leased under section 168(f)(8).

(iii) The adjusted basis to the lessor of property leased on or prior to December 1, 1982, under a transitional safe harbor lease shall be deemed to include all direct and indirect costs (including installation costs) described in subdivision (ii) allocable to such property that were incurred before it was leased despite the fact that such costs were not included in the lessor's adjusted basis of such property under the terms of the lease agreement, provided that the parties to such agreement reasonably believed that they had leased the whole of such property. Such costs will be treated as having been included in the lessor's adjusted basis of such safe harbor lease property on the date the lease agreement was executed without regard to any provisions in the lease agreement that limits the dollar amount of the permissible adjustment of the lessor's adjusted basis to such property. To qualify for inclusion of

such direct and indirect costs within the basis of such property, the parties to such agreement must file an amended Form 6793, the Safe Harbor Lease Information Return, no later than April 21, 1983, which reflects the parties' intent to include installation and other such costs within the basis of such property. For purposes of this subdivision, a transitional safe harbor lease is a lease either which was executed after July 1, 1982, and on or prior to December 1, 1982, or which includes some transitional safe harbor lease property, as defined in TEFRA section 208(d)(3), that was placed in service after July 1, 1982, and on or prior to December 1, 1982.

Q–3: What test will be applied in determining whether an item of property is constructed or acquired by the lessee?

A–3: Except as expressly provided in section 208(d)(3) (D) or (E) of TEFRA, the determination of whether and when any such events occurred with respect to an item of property will generally be made in accordance with the principles and precedents prior to TEFRA under the investment tax credit and depreciation allowance transitional provisions. See §§ 1.48–2(b)(6) and 1.167(c)–1(a)(2), which provide definitions of the term ''acquired'', and §§ 1.48–2(b)(1) and 1.167(c)–1(a)(1), which provide definitions of the term ''constructed by''. Also see Rev. Rul. 80–312, 1980–2 C.B. 21, which discusses the factors to be considered in determining when a taxpayer has control over a project being constructed.

In general, for purposes of TEFRA section 208(d)(3), construction of an item of property is considered to have commenced when physical work of a significant nature has begun with respect to the property. Thus, construction does not begin when parts or components which enter into construction are acquired. If property is assembled from purchased parts or components, the commencement of construction occurs when actual assembly of the property begins. If a taxpayer manufactures a major part or component of an item of property for itself, construction will be considered to have begun when the manufacturing of that part or component commences. However, construction of an item of property will not be considered as begun if physical work by the taxpayer relates to minor parts or components. Clearing and grading of land will be considered in determining when construction begins on an item of property only if they are directly associated with the construction of the property.

Q–4: Under section 168(f)(8)(J), the at-risk rules are liberalized for closely held lessors that engage in safe harbor leasing. These rules apply ''in the case of property placed in service after the date of enactment of this subparagraph,'' namely, after September 3, 1982.

Do the liberalized at-risk rules apply in the case where otherwise qualified property is placed in service by a lessee in August of 1982 but is leased by a corporate lessor subject to the at-risk rules after September 3, 1982?

A–4: The liberalized at-risk rule in section 168 (f)(8)(J) is applicable in this case because, in determining whether property is placed in service before or after the date of enactment of section 168(f)(8)(J), the relevant date is the date the property is placed in service by the lessor. Additionally, a closely held corporate lessor, which is not a personal service corporation, may lease transitional safe harbor lease property placed in service after September 3, 1982, under the liberalized at-risk rule.

Q–5: Is it necessary for property placed in service by a lessee in December of 1982 to be leased before January 1, 1983, in order to qualify under the general transitional rule of section 208(d)(3)(A) of TEFRA, which requires that the property be placed in service before January 1, 1983?

A–5: The legislative intent of this transitional rule was to provide a 3-month period after property is placed in service by a lessee in which a safe harbor lease could be entered into. *Cf.* section 209(c) of TEFRA (3-month window applies to true leases entered into after 1983). The legislative intent further was to permit property to qualify as transitional safe harbor lease property if it was placed in service by the end of 1982 by a lessee. Accordingly, transitional safe harbor lease property placed in service in 1982 by a lessee may be leased in a safe harbor lease transaction within 3 months after it is placed in service by the lessee without losing its status as transitional safe harbor lease property.

However, for all other purposes of the Code other than section 168(f)(8)(D)(i), section 168(f)(8)(D)(viii)(II) will apply and the property will be treated as originally placed in service not earlier than the date that the property is used under the lease. Thus, for example, if transitional safe harbor lease property is placed in service in December of 1982 and leased under section 168(f)(8) in January of 1983, the property will not lose its status as transitional safe harbor lease property, but the basis adjustment rules of section 48(g) will apply with respect to the property.

Q–6: Will a contract to acquire property be considered ''binding'' for purposes of section 208(d)(3)(A)(i) of TEFRA if the contract contains no liquidated damages clause?

A–6: Generally, an irrevocable contract which contains no provision for liquidated damages in the event of breach or cancellation would be considered binding. Morover, in determining the amount of the lessee's potential liability, the fair market value of the property will not be taken into account. For example, if a lessee entered into an irrevocable contract to purchase an asset for $100

and the contract contained no provision for liquidated damages, the contract would be considered binding notwithstanding the fact that the property at all times after July 1, 1982, had a value of $99 and under local law the seller could only recover the difference in the event the lessee failed to perform. On the other hand, if the contract by its terms provided for liquidated damages of less than 5 percent of the purchase price which is in lieu of any damages allowable by law, in the event of breach or cancellation, the contract would not be considered binding.

Q–7: How does the 50-percent limitation on lessors in section 168(i)(1) and the 45-percent limitation on lessees in section 168(f)(8)(D)(ii) apply to corporations which are part of an affiliated group filing consolidated returns?

A–7: Both the 50-percent limitation on lessors and the 45-percent limitation on lessees will be applied on a consolidated basis for corporations filing consolidated returns.

Q–8: Section 168(f)(8)(J) liberalized the at-risk rules for safe harbor leasing and provides that in cases where the safe harbor lessee would be considered the owner of the property without regard to the safe harbor lease, the lessor is considered to be at risk with respect to the property in an amount equal to the amount the lessee is considered at risk with respect to such property as determined under section 465.

Will a corporate lessor that would ordinarily be subject to the at-risk rules under section 465 be exempt from such rules under section 168(f)(8)(J) in a situation where acquisition of the leased property is financed with nonrecourse debt by a lessee that is not subject to the at-risk rules?

A–8: Yes. The liberalized at-risk rules of section 168(f)(8)(J) will apply in cases where the lessee's ACRS deductions and investment tax credit with respect to the property would not have been limited under the at-risk rules had the parties not elected treatment under section 168(f)(8).

Q–9: Section 168(f)(8)(J)(ii) excepts certain service corporations from the liberalized at-risk rules of section 168(f)(8)(J)(i). Does the exception in subdivision (ii) also extend to subsidiaries of such service corporations that file consolidated returns?

A–9: Yes. The liberalized at-risk rules of section 168(f)(8)(J)(i) will not apply to any subsidiary filing a consolidated return with a service organization described in section 168(f)(8)(J)(ii).

Q–10: Will property lose its status as transitional safe harbor lease property under section 208(d)(3) of TEFRA solely by reason of the fact that the person who is a party to a binding contract to acquire the property assigns his rights in the contract to another person?

A–10: When a person who is a party to a binding contract transfers his rights in the contract (or the property covered by the contract) to another person and the transferor (or a corporation which is a member of the same affiliated group as the transferor) will use the property under a lease for a period not less than 50 percent of the appropriate recovery period for the leased property under section 168(c), then to the extent of the transferred rights, this other person will succeed to the position of the transferor with respect to the binding contract and the property. Accordingly, under these circumstances, property will not lose its status as transitional safe harbor lease property.

In addition, property will not be disqualified as transitional safe harbor lease property solely by reason of a transfer by a person of his rights in a contract (or the property covered by the contract) in a transaction in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor (*e.g.*, transfers governed by sections 332, 351, 361, 721, and 731). Thus, for example, if a corporation entered into a binding contract for the construction or acquisition of property prior to July 1, 1982, and after such date assigned the contract to a corporation within the same affiliated group which files consolidated returns, the assignee will be entitled to treat the property acquired pursuant to the contract as transitional safe harbor lease property, assuming the property would have so qualified in the hands of the transferor. Similarly, if a joint venture or partnership between two corporations entered into a binding contract or commenced construction of property before July 2, 1982, but dissolved and distributed its assets to the partners or joint venturers after July 2, 1982, the joint venturers or partners may treat the assets as transitional safe harbor lease property, assuming the property would have so qualified had the joint venture or partnership remained in existence.

Q–11: During 1982, Corporation Y placed in service section 38 property with a total cost of $100X. On August 15, 1982, Corporation Y placed in service the last component of an entire facility within the meaning of § 5c.168(f)(8)–6(b)(2). The facility had a total cost basis of $40X, of which $30X was transitional safe harbor lease property within the meaning of section 208(d)(3) of TEFRA and $10X was not transitional safe harbor lease property. On November 1, 1982, Corporation Y sold and leased back under a section 168(f)(8) lease the $30X of transitional safe harbor lease property in the facility.

Will the entire facility rule in § 5c.168(f)(8)–6(b)(2) apply in this situation where the taxpayer has not leased all of the section 38 property in the facility?

A–11: No. The placed in service date, for purposes of the rule requiring that property be leased within 3 months after such property was placed in service by the lessee, would be determined under the entire facility rule in § 5c.168(f)(8)–6(b)(2) only if Corporation Y had leased all the qualified leased

property in the facility. Since Corporation Y leased only the $30X of transitional section 38 property, of the facility and did not lease the $10X of nontransitional property, Corporation Y may not rely on the entire facility rule of § 5c.168(f)(8)–6(b)(2) for purposes of determining the placed in service date for the property under the section 168(f)(8) lease.

Q–12: Assume the same facts as in Q–11, except that Corporation Y had also placed in service by August 15, 1982, $30X of miscellaneous machinery and equipment all of which was transitional safe harbor lease property within the meaning of section 208(d)(3) of TEFRA. On November 1, 1982, in addition to the $30X of transitional property in the facility, Corporation Y also sold and leased back under a separate section 168(f)(8) lease the $30X of miscellaneous machinery and equipment.

Will the entire facility rule in § 5c.168(f)(8)–6(b)(2) apply in this situation to the $30X of transitional property in the facility?

A–12: Yes. Since Corporation Y leased $30X of transitional machinery and equipment and the $30X of the facility which consisted of transitional property, Corporation Y can lease none of the nontransitional property in the facility because, by reason of the 45-percent cap on lessees contained in section 168(f)(8)(D) (ii) and (iii) and (I), it is not qualified leased property for purposes of section 168(f)(8). Thus, on the facts, Corporation Y has leased all the qualified leased property in the facility.

Q–13: Corporation X constructed a manufacturing complex consisting of three integrated operational components, each with a different ADR present class life midpoint, which together constitute an ''entire facility'' within the meaning of § 5c.168(f)(8)–6(b)(2). The last components of the facility were placed in service on August 15, 1982. On October 1, 1982, Corporation X sold to Corporation Z and leased back under section 168(f)(8) all the qualified leased property of the facility.

For purposes of the rule requiring that property be leased within 3 months after such property was placed in service by the lessee, will the leased components of the entire facility be considered placed in service by the lessee on August 15, 1982, the date the last components were placed in service, if the components are leased at one time pursuant to documents consisting of three section 168(f)(8) leases with different terms to reflect the different ADR midpoint lives of the qualified leased property in the facility?

A–13: Yes. If the entire facility rule in § 5c.168(f)(8)–6(b)(2) applies, the facility components which were placed in service prior to August 15, 1982, will be treated as placed in service by the lessee on August 15, 1982, for purposes of the 3-month rule. This rule will apply if all the qualified leased property of the facility is leased at one time. The documentation may be in the form of multiple, simultaneously executed agreements or maybe in the form of an agreement comprised of one or more parts or schedules. Each of the multiple agreements, or each of the parts or schedules of an agreement, may have different lease terms for property with different ADR midpoint lives, so long as each such agreement or part of schedule individually would be treated as a lease under section 168(f)(8), taking into account the entire facility rule, with lease terms commencing on the same date. A single transaction effected by multiple agreements or by an agreement with one or more parts or schedules will meet the maximum lease term requirement of § 5c.168(f)(8)–5(b) so long as each agreement or each part or schedule of an agreement meets the maximum lease term requirement.

Q–14: Under § 5c.168(f)(8)–6(b)(2), the special rule for facilities applies only if the entire facility is leased under a section 168(f)(8) lease.

Will a transaction not qualify under section 168(f)(8) if the parties, acting in good faith, omit an insubstantial portion of the qualified lease property from the lease?

A–14: No. The facility rule of § 5c.168(f)(8)–6(b)(2) will apply if the parties, acting in good faith, substantially comply with its terms.

Q–15: When will construction of an aircraft be considered to have been begun after June 25, 1981, and before February 20, 1982, for purposes of TEFRA section 208(d)(3)(D)?

A–15: Construction of an aircraft will be considered to have been begun after June 25, 1981, and before February 20, 1982, if during such period any of the following events occurred:

(i) Construction or reconstruction of a subassembly designated for the aircraft was commenced;

(ii) Construction of a lot increment of subassemblies (one or more of which was designated for the aircraft) was commenced; or

(iii) The stub wing join occurred.

Q–16: Does the definition of assets used in the manufacture or production of steel for purposes of TEFRA section 208(d)(2)(F) include all assets used in this function (such as electrical and steam generators and distribution equipment, coke oven by-product equipment) although not necessarily includible in the former ADR guideline class for primary steel mill products?

A–16: Yes, all assets that are used, in their primary function, as an integral part of the steel manufacturing or production process are included. *Cf.* § 1.48–1(d)(4). However, the steel manufacturing or production process does not include processing beyond the production of primary ferrous metals (as defined by the ADR Class for Manufacture of Primary Ferrous Metals).

Q–17: Where a qualified mass commuting vehicle meets the requirements for both the TEFRA section 208(d)(2) transitional rule and the TEFRA section 208(d)(5) special rule for mass commuting vehicles, which provision will control?

A–17: The general transitional rule of TEFRA section 208(d)(2) will apply. Thus, pursuant to TEFRA section 208(d)(2)(B), the provisions of section 168(f)(8)(J), but not the provisions of section 168(i)(1), will apply only to such property. If the general transitional rule does not apply to a specific mass commuting vehicle, the provision of section 168(i)(1) applies to the lessor who leases such vehicle.

Q–18: Does the definition of a qualified mass commuting vehicle include component parts of a qualified mass commuting vehicle—such as an undercarriage of a subway car or the costs of rehabilitation or reconstruction of a mass commuting vehicle (or component part thereof)?

A–18: Yes.

[T.D. 7850, 47 FR 50853, Nov. 10, 1982, as amended by T.D. 7879, 48 FR 11942, Mar. 22, 1983]

§ 5f.442–1 Temporary regulations relating to change of annual accounting period.

(a) *In general.* Notwithstanding paragraph (c) (1) and (2) of § 1.442–1 of the Income Tax Regulations, a corporation which—

(1) Is described in section 934(b) and is an inhabitant of the Virgin Islands (within the meaning of section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642)), or

(2) Has in effect an election under section 936 may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of § 1.442–1.

(b) *Effective date.* This section shall apply only if the statement described in paragraph (c)(1) of § 1.442–1 is filed after September 3, 1982.

[T.D. 7864, 47 FR 57921, Dec. 29, 1982; 48 FR 3367, Jan. 25, 1983]

§ 5f.6045–1 Returns of information of brokers and barter exchanges.

(a)–(b) [Reserved]

(c) *Reporting by brokers.*

(1)–(2) [Reserved]

(3) *Exceptions*—(i) *Sales effected for exempt recipients*—(A) *In general.* No return of information is required with respect to a sale effected for a customer that is an exempt recipient as defined in paragraph (c)(3)(i)(B) of this section.

(B) *Exempt recipient defined.* The term ''exempt recipient'' means—

(*1*) A corporation as defined in section 7701(a)(3), whether domestic or foreign;

(*2*) An organization exempt from taxation under section 501(a) or an individual retirement plan;

(*3*) The United States or a State, the District of Columbia, a possession of the United States, a political subdivision of any of the foregoing, a wholly-owned agency or instrumentality of any one or more of the foregoing or a pool or partnership composed exclusively of any of the foregoing;

(*4*) A foreign government, a political subdivision thereof, an international organization or any wholly-owned agency or instrumentality of the foregoing;

(*5*) A foreign central bank of issue (as defined in § 1.895–1(b)(1) as a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency);

(*6*) A dealer in securities or commodities registered as such under the laws of the United States or a State;

(*7*) A futures commission merchant registered as such with the Commodity Futures Trading Commission;

(*8*) A real estate investment trust (as defined in section 856);

(*9*) An entity registered at all times during the taxable year under the Investment Company Act of 1940;

(*10*) A common trust fund (as defined in section 584(a));

(*11*) A financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization; or

(*12*) A person registered under the Investment Advisers Act of 1940 who regularly acts as a broker within the meaning of paragraph (a)(1) of § 1.6045–1.

The terms used in this paragraph (c)(3)(i)(B) shall have the same meaning as those contained in 26 CFR 31.3452(c)–1 (revised as of April 1, 1983). A broker may treat any person described in paragraph (c)(3)(i)(B) (*1*) through (*11*) of this section as an exempt recipient without requiring such person to file an exemption certificate if the conditions of 26 CFR 31.3452(c)–1

(revised as of April 1, 1983) are satisfied. A broker may treat any person described in paragraph (c)(3)(i)(B)(*12*) of this section as an exempt recipient without requiring such person to file an exemption certificate if the person's status as a registered investment adviser who regularly acts as a broker within the meaning of paragraph (a)(1) of § 1.6045–1 is known generally in the investment community. Alternatively, a broker can require any exempt recipient to file an exemption certificate and may treat an exempt recipient who fails to file such certificate as a recipient which is not exempt.

(ii) *Multiple brokers.* In the case of a sale in which a broker is instructed to initiate the sale by a person that is an exempt recipient described in paragraph (c)(3)(i)(B) (*6*), (*7*), (*11*), or (*12*), of this section, no return of information is required with respect to the sale by the broker so instructed. In the case of a redemption of stock or retirement of securities, only the broker responsible for paying the holder redeemed or retired, or crediting the gross proceeds on the sale to such holder's account, is required to report the sale.

(iii) *Cash on delivery transactions.* In the case of a sale of securities through a ''cash on delivery'' account, a ''delivery versus payment'' account, or other similar account or transaction, only the broker which receives the gross proceeds from the sale against delivery of the securities sold is required to report the sale. If, however, such broker's customer is another broker (''second-party broker'') which is an exempt recipient, then only the second-party broker is required to report the sale.

(iv) *Custodians, trustees and partnerships.* No return of information is required with respect to a sale effected by a custodian or trustee in its capacity as such or a redemption of a partnership interest by a partnership provided the sale is otherwise reported by the custodian or trustee on a properly filed From 1041 or the redemption is otherwise reported by the partnership on a properly filed Form 1065, and all Schedule K–1 reporting requirements are satisfied.

(v) *Sales at issue price.* No return of information is required with respect to a sale of an interest in a regulated investment company (within the meaning of section 851) that computes its current price per share for purposes of distributions, redemptions, and purchases so as to stabilize the price per share at a constant amount that approximates its issue price or the price at which it was originally sold to the public.

(vi) *Obligor payments on certain obligations.* No return of information is required with respect to payments representing obligor payments on—

(A) Nontransferable obligations (including savings bonds, savings accounts, checking accounts, and NOW accounts);

(B) Obligations as to which the entire gross proceeds are reported by the broker on Form 1099 under provisions of the Internal Revenue Code other than section 6045 (including stripped coupons issued prior to July 1, 1982); or

(C) Retirement of short-term obligations (*i.e.*, obligations with a fixed maturity date not exceeding one year from the date of issue) that have original issue discount, as defined in section 1232(b)(1).

(vii) *Callable obligations.* No return of information is required with respect to payments representing obligor payments on demand obligations that also are callable by the obligor and that have no premium or discount.

(viii) *Foreign currency.* No return of information is required with respect to a sale of foreign currency other than a sale pursuant to a forward contract or regulated futures contract that requires delivery of foreign currency.

(ix) *Fractional share.* No return of information is required with respect to a sale of a fractional share of stock if the gross proceeds on the sale of the fractional share are less than $20.

(x) *Certain retirements.* No return of information is required from an issuer or its agent with respect to the retirement of book entry or registered form obligations as to which the relevant books and records indicate that no interim transfers have occurred.

(4) *Examples.* The following examples illustrate the application of the reporting requirements:

Example (1). A, an individual who is not an exempt recipient, places an order with B, a person generally known in the investment

community to be a federally registered broker/dealer, to sell A's stock in a publicly traded corporation. B, in turn, places an order to sell the stock with C, a second broker, which will execute the sale. B discloses to C the identity of the customer placing the order. C is not required to make a return of information with respect to the sale because C was instructed by B, an exempt recipient as defined in paragraph (c)(3)(i)(B)(6) of this section, to initiate the sale. B is required to make a return of information with respect to the sale.

Example (2). The facts are the same as in Example (1) except that B has an omnibus account with C so that B does not disclose to C whether the transaction is for a customer of B or for B's own account. C is not required to make a return of information with respect to the sale because C was instructed by B, an exempt recipient as defined in paragraph (c)(3)(i)(B)(6) of this section, to initiate the sale. B is required to make a return of information with respect to the sale.

Example (3). D, an individual who is not an exempt recipient, enters into a ''cash on delivery'' (''COD'') stock transaction by instructing K, a federally registered broker/dealer, to sell stock owned by D, and to deliver the proceeds to L, a custodian bank. In addition, concurrently with the above instructions, D instructs L to deliver D's stock to K (or K's designee) against delivery of such proceeds from K. The records of both K and L with respect to this transaction show an account in the name of D. Pursuant to paragraph (h)(1) of § 1.6045–1, D is considered the customer of K and L. Under paragraph (c)(3)(iii) of this section, K is not required to make a return of information with respect to the sale because K will pay the gross proceeds to L against delivery of the securities sold. L is required to make a return of information with respect to the sale.

Example (4). The facts are the same as in Example (3) except that E, a federally registered investment adviser who regularly acts as a broker within the meaning of paragraph (a)(1) of § 1.6045–1, instructs K to sell stock owned by D and to deliver the proceeds to L. In addition, concurrently with the above instructions, E instructs L to delivery D's stock to K (or K's designee) against delivery of such proceeds from K. The records of both K and L with respect to this transaction show an account in the name of E. Pursuant to paragraph (h)(1) of § 1.6045–1, E is considered the customer of K and L. Under paragraph (c)(3)(iii) of this section, K is not required to make a return of information with respect to the sale because K will pay the gross proceeds to L against delivery of the securities sold. In addition, L is not required to make a return of information with respect to the sale because L's customer, E, is another broker which is an exempt recipient. E is required to make a return of information with respect to the sale. The result would be the same even if the records of K and L with respect to this transaction show an account in the name of D.

Example (5). F, an individual who is not an exempt recipient, owns bonds that are held by G, a federally registered broker/dealer, in an account for F with G designated as nomineee for F. Upon the retirement of the bonds, the gross proceeds are automatically credited to the account of F. G is required to make a return of information with respect to the retirement because G is the broker responsible for making payment of the gross proceeds to F.

[T.D. 7960, 49 FR 22282, May 29, 1984]

PART 6a—TEMPORARY REGULATIONS UNDER TITLE II OF THE OMNIBUS RECONCILIATION ACT OF 1980

Sec.
6a.103A–1 Interest on mortgage subsidy bonds.
6a.103A–2 Qualified mortgage bond.
6a.103A–3 Qualified veterans' mortgage bonds.
6a.6652(g)–1 Failure to make return or furnish statement required under section 6039C.

AUTHORITY: 26 U.S.C. 7805.

Sections 6a.103A–2(k), (l), and (m) also issued under 26 U.S.C. 103A(j) (3), (4), and (5).

§ 6a.103A–1 Interest on mortgage subsidy bonds.

(a) *In general*—(1) *Mortgage subsidy bond.* A mortgage subsidy bond shall be treated as an obligation not described in section 103 (a)(1) or (a)(2). Thus, the interest on a mortgage subsidy bond is includable in gross income and subject to Federal income taxation.

(2) *Exceptions.* Any qualified mortgage bond and any qualified veterans' mortgage bond shall not be treated as a mortgage subsidy bond. See § 6a.103A–2 with respect to requirements of qualified mortgage bonds and § 6a.103A–3 with respect to requirements of qualified veterans' mortgage bonds.

(3) *Additional requirement.* In addition to the requirements of § 6a.103A–2, § 6a.103A–3, and this section, qualified mortgage bonds and qualified veterans' mortgage bonds shall be subject to the requirements of section 103(c) and the regulations thereunder.

(4) *Advance refunding.* On or after December 5, 1980, no tax-exempt obligation may be issued for the advance refunding of a mortgage subsidy bond (determined without regard to section 103A(b)(2) or § 6a.103A–1(a)(2)). An obligation issued for the refunding of a mortgage subsidy bond will be considered to be an advance refunding obligation if it is issued more than 180 days before the prior issue is discharged.

(5) *Registration.* Any obligation that is part of a qualified mortgage bond issue or qualified veterans' mortgage bond issue and which is issued after December 31, 1981, must be in registered form. The term ''in registered form'' has the same meaning as in § 1.6049–2(d). Thus, in general, an obligation is issued in registered form if it is registered as to both principal and interest and if its transfer must be effected by the surrender of the old instrument to the issuer and by either the reissuance of the old instrument to a new holder or the issuance of a new instrument to a new holder.

(b) *Definitions.* For purposes of §§ 6a.103A–2, 6a.103A–3, and this section the following definitions apply:

(1) *Mortgage subsidy bond.* (i) The term ''mortgage subsidy bond'' means any obligation which is issued as part of an issue a significant portion of the proceeds of which is to be used directly or indirectly to provide mortgages on owner-occupied residences.

(ii) For purposes of subdivision (i), a significant portion of the proceeds of an issue is used to provide mortgages if 5 percent or more of the proceeds are so used.

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

(3) *Bond.* The term ''bond'' means any obligation. The term ''obligation'' means any evidence of indebtedness.

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

(ii) For purposes of subdivision (i), obligations issued by or on behalf of any State or local governmental unit by constituted authorities impowered to issue such obligations are the obligations of such governmental unit. See § 1.103–1(b).

(5) *Proceeds.* The term ''proceeds'' includes original proceeds and investment proceeds. The terms ''original proceeds'' and ''investment proceeds'' shall have the same meaning as in § 1.103–13(b)(2). Unless otherwise provided in § 6a.103A–2 or this section, however, amounts earned from the investment of proceeds which are derived from qualified mortgage bonds in non-mortgage investments may not be commingled for the purposes of accounting for expenditures with other non-bond amounts, and such proceeds are investment proceeds even though not treated as investment proceeds for purposes of section 103(c). Repayments of principal on mortgages shall be treated as proceeds of an issue. Amounts (such as State appropriations or surplus funds) which are provided by the issuer or a private lender in conjunction with a qualified mortgage bond or a qualified veterans' mortgage bond shall not be treated as proceeds of a mortgage subsidy bond under this section. However, fees which are paid by a participating financial institution pursuant to an agreement with the issuer whereby such institution receives the right to originate or service mortgages and which are retained by an issuer are treated as original proceeds of the issue. Amounts provided by the issuer or a private lender may be treated as proceeds of an issue for purposes of section 103(c).

(6) *Single-family and owner-occupied residences.* Except for purposes of § 6a.103A–2 (g) and (h)(2)(ii), the terms ''single-family'' and ''owner-occupied,'' when used with respect to residences, include two-, three-, and four-family residences—

(i) One unit of which is occupied by the owner of the units, and

(ii) Which were first occupied as a residence at least 5 years before the mortgage is executed.

[T.D. 7780, 46 FR 34314, July 1, 1981; 46 FR 37890, July 23, 1981, as amended by T.D. 7794, 46 FR 55514, Nov. 10, 1981]

§ 6a.103A–2 Qualified mortgage bond.

(a) *In general*—(1) *Qualified mortgage bond.* A qualified mortgage bond shall not be treated as a mortgage subsidy

bond, and the interest on a qualified mortgage bond will be exempt from Federal income taxation.

(2) *Termination date.* No obligation issued after December 31, 1987, shall be treated as part of a qualified mortgage bond issue.

(b) *Definitions and special rules.* For purposes of this section and § 6a.103A–1, the following definitions apply:

(1) *Qualified mortgage bond.* The term ''qualified mortgage bond'' means one or more obligations issued by a State or any political subdivision thereof (hereinafter referred to as ''governmental unit'') as part of an issue—

(i) All of the original proceeds of which, net of the costs of issuing the obligations and proceeds invested in a reasonably required reserve fund (such net amount hereinafter in this section referred to as ''lendable proceeds''), are to be used to finance owner-occupied residences, and

(ii) Which meets each of the requirements of § 6a.103A–1 and this section.

A qualified mortgage bond does not include any bond that is an industrial development bond under section 103(b).

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

(3) *Targeted area residence.* The term ''targeted area residence'' means a residence in an area which is either—

(i) A qualified census tract, or

(ii) An area of chronic economic distress.

(4) *Qualified census tract.* (i) The term ''qualified census tract'' means a census tract in which 70 percent or more of the families have an income which is 80 percent or less of the State-wide median family income.

(ii) The determination under subdivision (i) shall be made on the basis of the most recent decennial census for which data are available. With respect to any particular bond issue, such determination may be based upon the decennial census data available 3 months prior to the date of issuance and shall not be affected by official changes to such data during or after such 3-month period.

(iii) The term ''census tract'' means a census tract as defined by the Secretary of Commerce.

(5) *Areas of chronic economic distress.* (i) The term ''area of chronic economic distress'' means an area designated by a State as meeting the standards established by that State for purposes of this subparagraph and approved by the Secretary and by the Secretary of Housing and Urban Development in accordance with the criteria set forth in (iii) of this subparagraph. A State may withdraw such designation at any time, with reasonable cause. Such withdrawal shall be effective upon notification by the State to the Assistant Secretary for Housing/Federal Housing Commissioner of the Department of Housing and Urban Development. Such withdrawal shall not affect the tax-exempt status of any outstanding issue of obligations.

(ii) For purposes of making a designation under this subparagraph, withdrawing a designation, or making any other submission, ''State'' means the governor of a State, or a State official commissioned by the governor or by State statute for such purposes.

(iii) The following criteria will be used in evaluating a proposed designation of an area of chronic economic distress:

(A) The condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units. Data pertinent to this criterion include the number and percentage of housing units that were constructed prior to 1940, the average age of the housing stock, the number and percentage of abandoned housing units, and the number and percentage of substandard residential units.

(B) The need of area residents for owner financing under a qualified mortgage bond issue as indicated by low per capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates. Data pertinent to this criterion include the per capita income of the population in the area, the number and percentage of families eligible to receive food stamps from a

program pursuant to 7 U.S.C. 2011, the number and percentage of families eligible to receive payments under the Aid to Families with Dependent Children program, and the unemployment rate.

(C) The potential for use of owner financing under a qualified mortgage bond issue to improve housing conditions in the area. Data pertinent to this criterion include the number and percentage of owner-occupied homes that are substandard, the number and percentage of families that are low- or moderate-income renters, and the number and percentage of substandard units in the area that will be improved through the use of owner financing provided by the proceeds of a qualified mortgage bond issue.

(D) The existence of a housing assistance plan which provides a displacement program and a public improvements and services program (similar to the Housing Assistance Plan (HAP) required by the Department of Housing and Urban Development under the Community Development Block Grant program (42 U.S.C. 5301 *et seq.*)).

This determination shall be based upon the most recent data availabe. The certification described in subdivision (iv)(C) shall satisfy the criteria set forth in subdivisions (C) and (D). A certification described in (iv)(D) shall satisfy the criteria set forth in subdivisions (A) and (B): *Provided,* That the majority of the households in the proposed area have incomes less than 80 percent of the median income for the standard metropolitan statistical area (SMSA) in which the proposed area is located or, if the proposed area is not within a SMSA, less than 80 percent of the median income for the State.

(iv) A proposal by the State that an area be approved as an area of chronic economic distress shall contain the following information:

(A) A description of the proposed area by its geographical limits.

(B) Maps of the State and of areas within the State that are qualified census tracts and existing or proposed areas of chronic economic distress.

(C) Where applicable, a certification of the local Area Manager of the Department of Housing and Urban Development in which the proposed area is located that the proposed area is a Neighborhood Strategy Area (NSA) under 24 CFR 570.301(c) promulgated pursuant to the Community Development Block Grant program or an area comparable to a NSA which has been reviewed and approved by the Area Manager as meeting the standards for an NSA.

(D) Where applicable, a certification from the HUD Area Manager with jurisdiction over the proposed area that the proposed area is within a geographic area which has been declared eligible for grants under the Urban Development Action Grant Program, Pursuant to 24 CFR 570.452, by the Secretary of Housing and Urban Development.

(E) Statistical and descriptive information pertinent to the criteria enumerated in subdivision (iii) of this subparagraph, and a succinct statement of how the information furnished satisfies those criteria. Such statistical information shall be based upon the most recent data available.

(F) If the State so desires, a written request for a conference prior to any adverse decision on the proposed designation.

(G) A certification by the Governor or designated official that the proposed designation conforms to these regulations.

(v) The proposed designation and the information furnished with it as required by subdivision (iv) of this subparagraph shall be submitted in triplicate to the Assistant Secretary for Housing/Federal Housing Commissioner of the Department of Housing and Urban Development (Attention: Office of State Agency and Bond Financed Programs, Rm. 6138, 451 7th Street, SW., Washington, D.C. 20410).

(vi) Only those areas of chronic economic distress that have been previously designated by the State and approved in accordance with this subparagraph at least 3 months prior to the date of issuance need to be taken into account for any particular bond issue. Residences located in areas designated as areas of chronic economic distress approved in accordance with this subparagraph within such 3-month period or after the date of issue, however, may be treated as targeted area

residences. However, for purposes of paragraph (h)(2), relating to the specified portion of proceeds to be placed in targeted areas, and paragraph (i)(3)(ii)(A), relating to the 1½ year temporary period, only areas approved as areas of chronic economic distress in accordance with this subparagraph at the time of issue may be taken into consideration.

(6) *Standard metropolitan statistical area.* A standard metropolitan statistical area (''SMSA'') is an area in and around a city of 50,000 inhabitants or more (or equivalent area) and defined by the Secretary of Commerce as an SMSA.

(7) *Statistical area.* The term ''statistical area'' means—

(i) An SMSA,

(ii) Any county (or portion thereof) which is not within an SMSA, or

(iii) If there is insufficient recent statistical information with respect to a county (or portion thereof) described in subdivision (ii) of this subparagraph, such other area as may be designated by the Commissioner, upon proper application, as a substitute for such county (or portion thereof).

For purposes of subdivisions (ii) and (iii) of this subparagraph, in Alaska, the entire State, and in Louisiana, a parish, shall be treated in a manner similar to a county.

(8) *Acquisition cost.* (i) The term ''acquisition cost'' means the cost of acquiring a residence from the seller as a completed residential unit. Acquisition cost includes the following:

(A) All amounts paid, either in cash or in kind, by the purchaser (or a related party or for the benefit of the purchaser) to the seller (or a related party or for the benefit of the seller) as consideration for the residence.

(B) If a residence is incomplete, the reasonable cost of completing the residence whether or not the cost of completing construction is to be financed with bond proceeds. For example, where a mortgagor purchases a building which is so incomplete that occupancy of the building is not permitted under local law, the acquisition cost includes the cost of completing the building so that occupancy of the building is permitted.

(C) Where a residence is purchased subject to a ground rent, the capitalized value of the ground rent. Such value shall be calculated using a discount rate equal to the yield on the issue (as defined in § 6a.103A–2(i)(2)(vi)).

(ii) The term ''acquisition cost'' does not include the following:

(A) The usual and reasonable settlement or financing costs. Settlement costs include titling and transfer costs, title insurance, survey fees, or other similar costs. Financing costs include credit reference fees, legal fees, appraisal expenses, ''points'' which are paid by the buyer (but not the seller, even though borne by the mortgagor through a higher purchase price) or other costs of financing the residence. However, such amounts will be excluded in determining acquisition cost only to the extent that the amounts do not exceed the usual and reasonable costs which would be paid by the buyer where financing is not provided through a qualified mortgage bond issue. For example, if the purchaser agrees to pay to the seller more than a pro rata share of property taxes, such excess shall be treated as part of the acquisition cost of a residence.

(B) The value of services performed by the mortgagor or members of the mortgagor's family in completing the residence. For purposes of the preceding sentence, the family of an individual shall include only the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. For example, where the mortgagor builds a home alone or with the help of family members, the acquisition cost includes the cost of materials provided and work performed by subcontractors (whether or not related to the mortgagor) but does not include the imputed cost of any labor actually performed by the mortgagor or a member of the mortgagor's family in constructing the residence. Similarly, where the mortgagor purchases an incomplete residence the acquisition cost includes the cost of material and labor paid by the mortgagor to complete the residence but does not include the imputed value of the mortgagor's labor or the labor of the mortgagor's family in completing the residence.

(C) The cost of land which has been owned by the mortgagor for at least 2 years prior to the date on which construction of the residence begins.

(iii) The following examples illustrate the provisions of subparagraph (8):

Example (1). A contracts with B, a builder of single-family residences, for the purchase of a residence. Under the terms of the contract, B will deliver a residential unit to A that contains an uncompleted recreation room and an unfinished third floor and which lacks a garage. Normally, a completed recreation room, a finished third floor and a garage are provided as part of the residence built by B. The contract price for the residence is $58,000. At the same time, A contracts with C, an affiliate of B, to complete the recreation room and third floor and to construct the garage for a contract price of $10,000. C will perform this work after A receives title to the unit from B. Under § 6a.103A–2(b)(8)(i)(A), the acquisition cost of A's completed residential unit is $68,000, which represents the contract price of the residence plus the cost of completion of the recreation room and third floor and construction of the garage.

Example (2). E owns a single-family residence which E has listed for sale. D contracts to purchase E's residence, and the contract provides for a selling price of $30,000. D also agrees to pay an unsecured debt in the amount of $5,000, which E owes to X, a local bank. D further agrees to purchase from E the refrigerator, stove, washer, and dryer located in E's residence for $500. Such amount is equal to the fair market value of such personalty. D also agrees to purchase the light fixtures, curtain rods, and wall-to-wall carpeting for a fair market value price of $700. Under § 6a.103A–2(b)(8)(i)(A), the acquisition cost of D's completed residential unit is $35,700. Such amount includes the $5,000 unsecured debt paid off by D. The $500 paid for the refrigerator, stove, washer, and dryer are not included because such items are not included within the definition of a residence under § 6a.103A–2(d)(4). Such definition does include, however, the light fixtures, curtain rods, and wall-to-wall carpeting purchased by D.

Example (3). F contracts with G to purchase G's home for $40,000. After purchasing the residence, F pays a party unrelated to G $3,000 for painting, minor repairs, and refinishing the floors. Under § 6a.103A–2(b)(8)(i)(A), the acquisition cost of the residence is $40,000. Such fix-up expenses are not treated as part of the acquisition costs. If G had incurred such fix-up expenses, however, F may not reduce his acquisition cost of the residence by such amounts.

(9) *Qualified home improvement loan.* (i) The term ''qualified home improvement loan'' means the financing (whether or not secured by a mortgage), in an amount which does not exceed $15,000 with respect to any residence, of alterations, repairs, and improvements on, or in connection with, an existing single-family, owner-occupied residence by the owner thereof, but only if such items substantially protect or improve the basic livability or energy efficiency of the residence.

(ii) Alterations, repairs, or improvements that satisfy the requirement of subdivision (i) of this subparagraph include the renovation of plumbing or electric systems, the installation of improved heating or air conditioning systems, the addition of living space, or the renovation of a kitchen area. Items that will not be considered to substantially protect or improve the basic livability of the residence include swimming pools, tennis courts, saunas, or other recreational or entertainment facilities.

(iii) If—(A) Two or more qualified home improvement loans are provided for the same residence, whether or not by the same lender, and

(B) Any person who had a present ownership interest in such residence at the time the previous qualified home improvement loan or loans were made has a present ownership interest in the residence at the time the subsequent qualified home improvement loan is made,

Then the allowable amount of the subsequent qualified home improvement loan shall be reduced by the amount, at origination, of any previous qualified home improvement loan, so that the sum of such loans does not exceed $15,000.

(iv) The following example illustrates the provisions of subparagraph (9):

Example. A and B jointly own a residence located in Town M. They obtain a qualified home improvement loan for $10,000 from Town M. A acquires B's interest in the residence. A applies to State X for a qualified home improvement loan. The maximum amount of a qualified home improvement loan which may be made by State X is $5,000, the amount that when added to the $10,000 previous loan from Town M does not exceed $15,000.

(10) *Qualified rehabilitation loans.* (i) The term ''qualified rehabilitation loan'' means any owner financing provided in connection with—

(A) A qualified rehabilitation, or

(B) The acquisition of a residence with respect to which there has been a qualified rehabilitation,

But only if the mortgagor to whom such financing is provided is the first resident of the residence after completion of the rehabilitation. Where there are two or more mortgagors of a rehabilitation loan, the first residency requirement is met if any of the mortgagors meets the first residency requirement.

(ii) The term ''qualified rehabilitation'' means any rehabilitation of a residence if—

(A) There is a period of at least 20 years between the date on which the building was first used and the date on which physical work on such rehabilitation begins,

(B) 75 percent or more of the existing external walls of such building are retained in place as external walls in the rehabilitation process, and

(C) The expenditures for such rehabilitation are 25 percent or more of the mortgagor's adjusted basis in the residence (including the land on which the residence is located).

(iii) For purposes of (A) and (B), the rules applicable to the investment tax credit for qualified rehabilitated buildings under section 48(g)(1) (A)(iii) and (B) shall apply. However, unlike section 48(g)(1)(B), once a building meets the 20-year test, more than one rehabilitation of that building within a 20-year period may qualify as a qualified rehabilitation.

(iv) The adjusted basis to the mortgagor is the mortgagor's adjusted basis for purposes of determining gain or loss on the sale or exchange of a capital asset (as defined in section 1221). The mortgagor's adjusted basis shall be determined as of the date of completion of the rehabilitation, or, if later, the date the mortgagor acquires the residence, *i.e.*, the date on which the mortgagor includes in basis any amounts expended for rehabilitation that are expended for capital assets.

(v) The amounts expended by the mortgagor for rehabilitation include all amounts expended for rehabilitation regardless of whether the amounts expended were financed from the proceeds of the loan or from other sources, and regardless of whether the expenditure is a capital expenditure, so long as the expenditure is made during the rehabilitation of the residence and is reasonably related to the rehabilitation of the residence. The value of services performed by the mortgagor or members of the mortgagor's family (as used in § 6a.103A–2(b)(8)(ii)(B)) in rehabilitating the residence will not be included in determining the rehabilitation expenditures for purposes of the 25-percent test.

(vi) Where a mortgagor purchases a residence that has been substantially rehabilitated, the 25-percent test is determined by comparing the total expenditures made by the seller for the rehabilitation of the residence with the acquisition cost of the residence to the mortgagor. The total expenditures made by the seller for rehabilitation do not include the cost of acquiring the building or land but do include all amounts directly expended by the seller in rehabilitating the building (excluding overhead and other indirect charges).

(c) *Good faith compliance efforts*—(1) *Mortgage eligibility requirements.* An issue of qualified mortgage bonds which fails to meet one or more of the requirements of paragraphs (d), (e), (f), and (j) of this section shall be treated as meeting such requirements if each of the following provisions is met.

(i) The issuer in good faith attempted to meet all such requirements before the mortgages were executed. Good faith requires that the trust indenture, participation agreements with loan originators, and other relevant instruments contain restrictions that permit the financing of mortgages only in accordance with such requirements. In addition, the issuer must establish reasonable procedures to ensure compliance with such requirements. Such procedures include reasonable investigations by the issuer or its agent to determine that the mortgages satisfy such requirements.

(ii) Ninety-five percent or more of the lendable proceeds (as defined in § 6a.103A–2(b)(1)) that were devoted to

owner financing were devoted to residences with respect to which, at the time the mortgages were executed or assumed, all such requirements were met. In determining whether the proceeds are devoted to owner financing which meets such requirements, the issuer may rely on an affidavit of the mortgagor that the property is located within the issuer's jurisdiction and an affidavit of the mortgagor and the seller that the requirements of § 6a.103A–2(f) are met. The issuer may also rely on his own or his agent's examination of copies of income tax returns which were filed with the Internal Revenue Service and which are provided by the mortgagor or obtained by the issuer or loan originator in accordance with the procedures set forth in § 301.6103(c)–1 which indicate that, during the preceding 3 years, the mortgagor did not claim deductions for taxes or interest on indebtness with respect to real property constituting his principal residence, in addition to an affidavit of the mortgagor that the requirements of § 6a.103A–2(e) are met. The mortgagor may also provide the issuer or his agent with an affidavit that the mortgagor was not required to file such return in accordance with section 6012 during one or all of the preceding 3 years. Where a particular mortgage fails to meet more than one of these requirements, the amount of the mortgage will be taken into account only once in determining whether the 95-percent requirement is met. However, all of the defects in the mortgage must be corrected pursuant to paragraph (c)(1)(iii) of this section.

(iii) Any failure to meet such requirements is corrected within a reasonable period after such failure is discovered. For example, where a mortgage fails to meet one or more of such requirements those failures can be corrected by calling the nonqualifying mortgage or by replacing the nonqualifying mortgage with a qualifying mortgage.

(iv) *Examples.* The following examples illustrate the application of paragraph (c)(1) of this section:

Example (1). State X issues obligations to be used to provide mortgages for owner-occupied residences. X contracts with bank M to originate and service the mortgages. The trust indenture and participation agreement require that the mortgages meet the mortgage eligibility requirements referred to in paragraph (c)(1). In addition, pursuant to procedures established by X, M obtains a signed affidavit from each applicant that the applicant intends to occupy the property as his or her principal residence within 60 days after the final closing and thereafter to maintain the property as his or her principal residence. Further, M obtains from each applicant copies certified by the Internal Revenue Service of the applicant's Federal tax returns for the preceding 3 years and examines each statement to determine whether the applicant has claimed a deduction for taxes on real property which was the applicant's principal residence pursuant to section 164(a)(1) or a deduction pursuant to section 163 for interest paid on a mortgage secured by real property which was the applicant's principal residence. Also in accordance with X's procedures, M obtains from each applicant a signed affidavit as to facts that are sufficient for M to determine whether the residence is located within X's jurisdiction and affidavits from the seller and the buyer that the purchase price and the new mortgage requirements have been met, and neither M nor X knows or has reason to believe that such affidavits are false. The mortgage instrument provides that the mortgage may not be assumed by another person unless X determines that the principal residence, 3-year, and purchase price requirements are met at the time of the assumption. These facts are sufficient evidence of the good faith of the issuer and meet the requirements of paragraph (c)(1)(i). Further, if 95 percent of the lendable proceeds are devoted to owner financing which according to these procedures meet the requirements of paragraphs (d), (e), (f), and (i), then the issue meets the requirements of paragraph (c)(1)(ii).

Example (2). State Y issues obligations to be used to provide mortgages for owner-occupied residences. Y contracts with bank N to originate and service the mortgages. The trust indenture and participation agreement require that the mortgagor certify compliance with the requirements referred to in paragraph (c)(1). By itself, this certification is not sufficient evidence of the good faith of the issuer to meet the requirements referred to in paragraph (c)(1).

Example (3). The facts are the same as in Example 1, except that M discovers through a verification procedure required by X that, at the time of closing, A fraudulently executed the residencey affidavit. Instead of occupying the property as a principal residence, A leased the property to B for one year. A did not use the property as his residence during the lease term. Thus, at the time that A's mortgage was executed the

residence failed to meet the requirements of paragraph (d) of this section.

More than 95 percent of the lendable proceeds of the issue were devoted to residences which met all the requirements referred to in paragraph (c)(1) at the time the mortgages were executed. Furthermore, pursuant to a provision in the mortgage instrument M called the loan. Any failures with respect to other mortgages are corrected by M. Based on these facts, the issue meets the requirements of subparagraph (c)(1).

Example (4). The facts are the same as in Example (1), except that the issuer requires copies of the applicant's signed tax returns that were filed with the Internal Revenue Service for the preceding 3 years but does not require that such returns be certified. If 95 percent of the lendable proceeds are devoted to owner financing which according to these procedures meet the requirements of paragraphs (d), (e), (f), and (i), then the issue meets the requirements of paragraph (c)(1)(ii).

(2) *Nonmortgage eligibility requirements.* An issue of qualified mortgage bonds which fails to meet one or more of the requirements of paragraphs (g), (h), and (i) of this section and § 6a.103A–1(a)(5) shall be treated as meeting such requirements if each of the following provisions is met.

(i) The issuer in good faith attempted to meet all such requirements. This good faith requirement will be met if all reasonable steps are taken by the issuer to ensure that the issue complies with these requirements.

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

(iii) The following examples illustrate the application of this subparagraph (2):

Example (1). City X issues obligations to finance owner-occupied residences. However, despite taking all reasonable steps to determine accurately the size of the market share limitation, as provided in paragraph (g)(3), the limit is exceeded because the amount of the mortgages originated in the area during the past 3 years is incorrectly computed as a result of mathematical error. Such facts are sufficient evidence of the good faith of the issuer to meet the requirements of paragraph (c)(2).

Example (2). City Y issues $25 million of bonds to finance single-family, owner-occupied homes. Attorney A gives an opinion that the bonds satisfy the arbitrage requirements of § 6a.103A–2(i) and § 6a.103A–1(a)(3). In fact, however, the legal conclusion reached by A is erroneous, and the bonds do not meet the requirements of § 6a.103A–2(i). The issue does not meet the requirements of subparagraph (c)(2) because the erroneous opinion does not constitute inadvertent error.

(d) *Residence requirements*—(1) *In general.* An issue meets the requirements of this paragraph only if all of the residences for which owner financing is provided under the issue meet the requirements of this paragraph. A residence meets the requirements of this paragraph only if—

(i) It is a single-family residence (as defined in § 6a.103A–1(b)(6)) which, at the time the mortgage is executed or assumed, can reasonably be expected by the issuer to become the principal residence of the mortgagor within a reasonable time after the financing is provided; and

(ii) It is located within the jurisdiction of the authority issuing the obligation.

(2) *Affidavit.* The requirements of subparagraph (1)(i) of this paragraph may normally be met if the mortgagor executes an affidavit of his intent to use the residence as his principal residence within a reasonable time (*e.g.,* 60 days) after the financing is provided.

(3) *Principal residence.* Whether a residence is used as a principal residence depends upon all the facts and circumstances of each case, including the good faith of the mortgagor. A residence which is primarily intended to be used in a trade or business shall not satisfy the requirements of this paragraph. For purposes of the preceding sentence, any use of a residence which does not qualify for a deduction allowable for certain expenses incurred in connection with the business use of a home under section 280A shall not be considered as a use in a trade or business. Except for certain owner-occupied residences described in paragraph (b)(6) of § 6a.103A–1, a residence more than 15 percent of the total area of which is reasonably expected to be used primarily in a trade or business does not satisfy the requirements of this subparagraph. Further, a residence used as an investment property or a recreational home does not satisfy the requirements of this subparagraph.

(4) *Residence.* (i) The term ''residence'' includes stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)). It does not include property such as an appliance, a piece of furniture, a radio, *etc.*, which, under applicable local law, is not a fixture. The term also includes factory-made housing which is permanently fixed to real property. The determination of whether factory-made housing is permanently fixed to real property shall be made on the basis of the facts and circumstances of each particular case.

(ii) *Land.* Land appurtenant to a residence shall be considered as part of the residence only if such land reasonably maintains the basic livability of the residence and does not provide, other than incidentally, a source of income to the mortgagor.

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

Example (1). A contracts to purchase a new residence from B. Since B is unable to move from the residence until 1 month after the scheduled closing date, A agrees to lease the residence to B for 1 month at a rent equal to the fair rental value. A applies for a mortgage to be provided from the proceeds of a qualified mortgage bond. In light of all the facts and circumstances in the case, the fact that A temporarily leases the residence to B does not prevent the residence from being considered as property that can reasonably be expected to be used as A's principal residence within a reasonable period of time after financing is provided.

Example (2). C contracts to purchase a new residence located on 2 acres of land in city X. City X has a zoning regulation which prevents the subdividing of any lot in that part of the city for use as a private residence into parcels of less than 2 acres. In light of all the facts and circumstances in the case, the fact that the residence is located on 2 acres of land appurtenant to the residence does not prevent the entire property from being considered as property to be used by C as a residence.

Example (3). D contracts to purchase a new residence located on 40 acres of land that D intends to farm. Any financing provided for the purchase of that portion of the property intended to be farmed will not be considered as financing provided for an owner-occupied residence.

(e) *3-year requirement*—(1) *In general.* An issue meets the requirements of this paragraph only if each of the mortgagors to whom owner financing is provided under the issue meets the requirements of this paragraph. A mortgagor meets the requirements of this paragraph only if the mortgagor had no present ownership interest in a principal residence at any time during the 3-year period prior to the date on which the mortgage is executed. For purposes of the preceding sentence, the mortgagor's interest in the residence with respect to which the financing is being provided shall not be taken into account.

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

(i) Any financing provided with respect to a targeted area residence (as defined in § 6a.103A–2(b)(3)),

(ii) Any qualified home improvement loan (as defined in § 6a103A–2(b)(9)), and

(iii) Any qualified rehabilitation loan (as defined in § 6a.103A–2(b)(10)).

(3) *Multiple mortgagors.* In the event that there is more than one mortgagor with respect to a particular residence, each of such mortgagors must meet the 3-year requirement. A person who is liable under a note secured by the mortgage but who does not have a present ownership interest in a residence subject to the mortgage need not meet the 3-year requirement. For example, where a parent of a home purchaser cosigns the note for a child but the parent takes no interest in the residence, it is not necessary that the parent meet the 3-year requirement since the parent is not a mortgagor of the residence.

(4) *Included interests.* Examples of interests which constitute present ownership interests are the following:

(i) A fee simple interest;

(ii) A joint tenancy, a tenancy in common, or tenancy by the entirety;

(iii) The interest of a tenant-shareholder in a cooperative;

(iv) A life estate;

(v) A land contract (*i.e.*, a contract pursuant to which possession and the benefits and burdens of ownership are transferred although legal title is not transferred until some later time); and

(vi) An interest held in trust for the mortgagor (whether or not created by the mortgagor) that would constitute a

present ownership interest if held directly by the mortgagor.

(5) *Excluded interests.* Examples of interests which do not constitute present ownership interests are the following:

(i) A remainder interest;

(ii) A lease with or without an option to purchase;

(iii) A mere expectancy to inherit an interest in a principal residence;

(iv) The interest that a purchaser of a residence acquires on the execution of a purchase contract; and

(v) An interest in other than a principal residence during the previous 3 years.

(f) *Purchase price requirements*—(1) *In general.* An issue meets the requirements of this paragraph only if the acquisition cost (as defined in § 6a.103A–2(b)(8)) of each residence, other than a targeted area residence, for which owner financing is provided does not exceed 90 percent of the average area purchase price applicable to such residence. In the case of a targeted area residence (as defined in § 6a.103A–2(b)(3)), the acquistion cost may not exceed 110 percent of the average area purchase price applicable to such residence.

(2) *Exception.* Paragraph (1) shall not apply with respect to any qualified home improvement loan (as defined in § 6a.103A–2(b)(9)).

(3) *Average area purchase price.* The term ''average area purchase price'' means, with respect to any residence, the average purchase price of all single-family residences in the statistical area (as defined in § 6a.103A–2(b)(7)) in which the residence being financed is located for the most recent 12-month period for which sufficient statistical information is available. The determination whether a particular residence meets the purchase price requirement shall be made as of the date on which the commitment to provide the financing is made or, if earlier, the date of purchase of the residence.

(4) *Special rules.* (i) In the case of a qualified rehabilitation loan, the requirements of this paragraph are met if the mortgagor's adjusted basis in the property as of the completion of the rehabilitation (including the cost of the rehabilitation) meets the requirements of paragraph (f)(1). For this purpose, a rehabilitated residence is to be treated as a residence which has been previously occupied.

(ii) The determination of average area purchase price shall be made separately with respect to—

(A) Residences which have not been previously occupied;

(B) Residences which have been previously occupied; and

(C) One-family, two-family, three-family, and four-family residences.

(5) *Safe harbor limitation.* (i) For purposes of meeting the requirements of this paragraph, an issuer may rely upon average area purchase price limitations published by the Treasury Department for the statistical area in which a residence is located. These safe harbor limitations will be effective for the period stated at the time of publication. An issuer may use a limitation different from such safe harbor limitation for any statistical area (as defined in § 6a.103A–2(b)(7)) for which the issuer has more accurate and comprehensive data.

(ii) The following example illustrates the application of subparagraph (5)(i):

Example. The average area purchase price safe harbor limitation for new single-family residences published by the Treasury Department for the second half of 1981 for the jurisdiction of governmental unit X is $41,500. However, on July 1, 1981, X determines that its average area purchase price for new single-family residences is actually $43,000. Such determination is based on a comprehensive survey of residential housing sales in the jurisdiction over the previous calendar year. The data accumulated are based on records maintained by the county clerk's office in X's jurisdiction, which enables X to compute average area purchase prices separately for new and used residences and for one-, two-, three-, and four-family residences. X cannot reasonably update such data more often than once a year. X may use average area purchase prices computed from these data for mortgages made from July 1, 1981, through June 30, 1982, rather than the safe harbor published by the Treasury Department.

(g) *Limitation on aggregate amount of qualified mortgage bonds issued during any calendar year*—(1) *In general.* An issue meets the requirements of this section only if the aggregate amount of bonds issued pursuant thereto, when added to the sum of (i) the aggregate amount of qualified mortgage bonds

previously issued by the issuing authority during the calendar year and (ii) the amount of qualified mortgage bonds which the issuing authority previously elected not to issue under section 25(c)(2)(A)(ii) and the regulations thereunder during the calendar year, does not exceed the applicable limit (''market limitation'') for such authority for such calendar year.

(2) *State housing finance agency.* Except as provided in paragraph (g)(4) of this section, the market limitation for any State housing finance agency for any calendar year shall be 50 percent of the State ceiling for such year. For purposes of the preceding sentence, if any State has more than one housing finance agency all such agencies shall be treated as a single agency.

(3) *Other issuers.* Except as provided in paragraph (g)(4), the market limitation for any issuing authority (other than a State housing finance agency) for any calendar year is an amount equal to that authority's proportionate share of 50 percent of the State ceiling amount for such calendar year. The proportionate share is an amount which bears the same ratio to 50 percent of the State ceiling for such year as—

(i) The average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences located within the jurisdiction of such issuing authority, bears to

(ii) An average determined in the same way for the entire State.

(4) *Constitutional home rule city.* (i) In determining the market limitation for any constitutional home rule city (as defined in paragraph (b)(2) of this section), subparagraph (3) shall be applied by substituting ''100 percent'' for ''50 percent.''

(ii) In a State with one or more constitutional home rule cities, in computing the market limitation for issuers other than constitutional home rule cities, the State ceiling amount for any calendar year shall be reduced by the aggregate market limitation for such year for all constitutional home rule cities in the State.

(5) *Overlapping jurisdictions.* (i) For purposes of subparagraph (3) of this paragraph, if an area is within the jurisdiction of two or more governmental units, such area shall be treated as only within the jurisdiction of the unit having jurisdiction over the smallest geographical area. However, the governmental unit with jurisdiction over the smallest geographical area may enter into a written agreement to allocate all or a designated portion of such overlapping area to the governmental unit having jurisdiction over the next smallest geographical area.

(ii) Where two governmental units have authority to issue mortgage subsidy bonds and both governmental units have jurisdiction over the identical geographical area, the aggregate principal amount of mortgages on residences located within that area shall be allocated to the governmental unit having broader sovereign powers.

(6) *State ceiling.* (i) Except as provided in paragraph (g)(6)(v), the State ceiling applicable to any State for any calendar year shall be the greater of—

(A) 9 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences located within the jurisdiction of such State, or

(B) $200,000,000.

Only single-family owner-occupied residences (without regard to the definition of such term under §6a.103A–1(b)(6)) may be used in determining the market limitation regardless of whether or not residences with up to four family units are to be financed by the program. First and second mortgages or mortgages used to refinance an existing mortgage shall be used in making such determination. Liens, special assessments, and similar encumbrances may not be taken into consideration.

(ii) For mortgages on residences with more than one family unit, the full amount of the mortgage shall be applied toward the market limitation and not merely that portion allocable to the owner-occupied unit.

(iii) For purposes of determining the State ceiling amount applicable to any State for any calendar year an issuer may rely upon the State ceiling

amount published by the Treasury Department for such calendar year. An issuer may rely on a different State ceiling amount than such safe-harbor limitation where the issuer has made a more accurate and comprehensive determination of such amount.

(iv) The following example illustrates the application of subparagraphs (3) and (6) of this paragraph (g):

Example. Pursuant to the allocation rule provided in subparagraph (3), City Y determines that its maximum market limitation in 1981 is $15,000,000. This determination is based on records maintained by the county clerk's office from which data for the preceding 3 years have been accumulated by City Y as to the number of sales of single-family homes in City Y's jurisdiction, the purchase price in each such sales transaction, the number of such sales that were financed by mortgages and the volume of second mortgages and refinancing on previously purchased owner-occupied single-family residences. This information, combined with estimates made by City Y of the average mortgage-loan-to-purchase-price ratio and the ratio of sales of single-family, owner-occupied residences to all sales of single-family residences from a representative sample of sales transactions, enables Y to estimate the preceding 3 years' annual aggregate mortgage volume by using the following formula:

$$v = 1/3 \sum_{i=t-3}^{t-1} \left(u_i . w_i . x_i . y_i . z_i\right) + a_i,$$

where

v=The preceding 3 years' average annual aggregate volume of mortgages on single-family, owner-occupied residences in City Y,

u_i=Number of sales of single-family residences,

w_i=Average purchase price of all sales,

x_i=Percent of all sales transactions that were financed with mortgages,

y_i=Estimated average mortgage-loan-to-purchase-price ratio,

z_i=Estimated percent of sales that were owner-occupied residences,

a_i=Total volume of second mortgages and refinancing on previously purchased owner-occupied, single-family residences,

i=The annual period of calculation, and

t=The current year.

City Y determines its applicable limit for 1981 based on the following formula:

L=0.5 (v/s) r, where

L=Market limitation for City Y for the current year,

s=The preceding 3 years' average annual aggregate volume of mortgages on single-family, owner-occupied residences in State X, and

r=Ceiling for State X (*i.e.*, r=the greater of .09s or $200,000,000).

City Y may use the Treasury estimate of s which will be published with the mortgage volume safe harbor limitation. City Y may rely on its determination of its market limitation for obligations issued during 1981.

(v) *Reduction in State ceiling.* If for any calendar year an issuer of mortgage credit certificates, as defined in section 25 and the regulations thereunder, fails to meet the requirements of section 25 (d)(2) and the regulations thereunder, relating to the limit on the aggregate amount of mortgage credit certificates that may be issued, the applicable State ceiling under paragraph (g)(6)(i) of this section for the State in which the program operates will be reduced by 1.25 times the correction amount (as defined in section 25 (f)(2) and the regulations thereunder) with respect to that failure for the calendar year following the calendar year in which the Commissioner determines the correction amount with respect to that failure.

(7) *Excess obligations.* Where an issue of obligations when added to the aggregate amount of bonds issued by the same issuing authority in the same calendar year exceeds the market limitation determined in accordance with this paragraph (g), no portion of the issue will be treated as a qualified mortgage bond issue, and interest on such obligations shall be subject to Federal income taxation. However, previously issued qualified mortgage bond issues which met the market limitation at the time of their issuance will not cease to be qualified mortgage bond issues even though a subsequent issue causes the aggregate amount of obligations to exceed such limitation for a calendar year.

(8) *Transitional rule obligations.* In applying this paragraph (g) to any calendar year, there shall not be taken into account any bond which, by reason of section 1104 of the Mortgage Subsidy Bond Tax Act of 1980 (94 Stat. 2670) (relating to transitional rules), receives the same tax treatment as bonds issued on or before April 24, 1979.

(9) *Procedure for providing a different allocation.* (i) A State may, by law enacted after December 5, 1980, provide a different formula for allocating the State ceiling amount among the governmental units in such State (other than constitutional home rule jurisdictions) having authority to issue qualified mortgage bonds.

(ii) The governor of any State may proclaim a different formula than provided in subparagraphs (g)(2) and (g)(3) for allocating the State ceiling amount among the governmental units in such State having authority to issue qualified mortgage bonds. The authority of the governor to proclaim a different formula shall not apply after the earlier of—

(A) The 1st day of the 1st calendar year beginning after the 1st calendar year after 1980 during which the legislature of the State met in regular session, or

(B) The effective date of any State legislation dealing with such ceiling enacted after December 5, 1980.

If, on or before either date, the governor of any State exercises the authority to provide a different allocation, such allocation shall be effective until the date specified in (B).

(iii) Unless otherwise provided in a State constitutional amendment or by law changing the home rule provisions adopted in the manner provided by the State constitution, the allocation of that portion of the State ceiling which is allocated to any constitutional home rule city may not be changed by the governor or State legislature unless such city agrees to such different allocation.

(iv) Where a State elects to make a different allocation in accordance with subdivision (i) or (ii) of this subparagraph, the determination as to whether a particular bond issue meets the requirements of paragraph (g) of this section will be based upon the allocation in effect at the time such bonds were issued. Moreover, the authority to provide for a different allocation may not be used directly or indirectly to increase the State ceiling amount.

(v) An issuing authority located in a State with one or more constitutional home rule cities may use an alternative method to those provided in subparagraphs (2), (3), and (4) for determining such issuing authority's market limitation if, prior to issuing any obligations for the calendar year, it demonstrates to the satisfaction of the Commissioner that—

(A) The use of the methods provided in subparagraph (2), (3), or (4) would impose an unreasonable hardship on the issuing authority, and

(B) Such alternative method is reasonable.

(h) *Portion of loans required to be placed in targeted areas*—(1) *In general.* An issue meets the requirements of this paragraph only if—

(i) The portion of the lendable proceeds (as defined in §6a.103A–2(b)(1)) of the issue specified in subparagraph (2) is made available for owner financing of targeted area residences (as defined in §6a.103A–2(b)(3)) for at least 1 year after the date on which owner financing is first made available with respect to targeted area residences, and

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

Proceeds are considered first made available with respect to targeted area residences on the date on which any financing of mortgages with the lendable proceeds of an issue first becomes available. Reasonable diligence requires that the issuer and the loan originators use reasonable efforts in trying to place mortgages in targeted areas, such as by advertising that mortgage funds are available for targeted areas. Reasonable diligence is not shown by merely providing in the governing instruments that the required amount be set aside for targeted areas.

(2) *Specified portion.* The specified portion of lendable proceeds of an issue required to be made available in targeted areas is the lesser of—

(i) 20 percent of the lendable proceeds, or

(ii) 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences in targeted areas within the jurisdiction of the issuing authority.

(3) *Safe harbor.* For purposes of computing the required portion of proceeds

specified in subparagraph (2)(ii) of this paragraph, where such provision is applicable, an issuer may rely upon the amount produced by the following formula:

$$P = .2(X/Y \times Z),$$

where

P=Required portion to be made available in targeted areas,

X=Average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences within the State in which the issuing jurisdiction is located,

Y=The total population within the State, based on the most recent decennial census for which data are available, and

Z=The total population in the targeted areas located within the issuer's jurisdiction, based on the most recent decennial census for which data are available.

The issuing jurisdiction may use the Treasury Department estimate of X which will be published with the mortgage volume safe harbor limitation.

(4) *Minimum amount.* (i) The specified portion required to be made available in targeted areas is a minimum amount. More than the minimum amount may be (but need not be) made available in targeted areas.

(ii) With respect to any proceeds not required to be made available in targeted areas, the requirements of this paragraph do not abrogate the requirement of the arbitrage rules that due diligence be used in placing lendable proceeds into mortgages.

(i) *Arbitrage and investment gain*—(1) *In general.* An issue meets the requirements of this paragraph only if such issue meets the requirements of subparagraphs (2), (3), and (4) of this paragraph. For purposes of these requirements, all determinations of yield, effective interest rates, and amounts required to be paid or credited to mortgagors under paragraph (i)(4)(i) of this section shall be made on an actuarial basis taking into account the present value of money. The requirements of section 103A(i) and this paragraph are applicable in addition to the requirements of section 103(c) and §§ 1.103–13, 1.103–14, and 1.103–15.

(2) *Effective rate of mortgage interest not to exceed bond yield by more than 1 percentage point*—(i) *Maximum yield.* An issue of qualified mortgage bonds shall be treated as meeting the requirements of this subparagraph only if the excess of—

(A) The effective rate of interest on the mortgages financed by the issue, over

(B) The yield on the issue,

is not greater over the term of the issue than 1 percentage point.

(ii) *Effective rate of interest.* (A) In determining the effective rate of interest on any mortgage for purposes of this subparagraph, there shall be taken into account all fees, charges, and other amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue. Such amounts include points, commitment fees, origination fees, servicing fees, and prepayment penalties paid by the mortgagor.

(B) Items that shall be treated as borne by the mortgagor and shall be taken into account in calculating the effective rate of interest also include—

(*1*) All points, commitment fees, origination fees, or similar charges borne by the seller of the property;

(*2*) The excess of any amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable costs incurred by a person acquiring like property where owner financing is not provided through the use of qualified mortgage bonds.

(C) The following items shall not be treated as borne by the mortgagor and shall not be taken into account in calculating the effective rate of interest:

(*1*) Any expected rebate of arbitrage profit (as required by § 6a.103A–2(i)(4)).

(*2*) Any application fee, survey fee, credit report fee, insurance fee or similar settlement or financing cost to the extent such amount does not exceed amounts charged in such area in cases where owner financing is not provided through the use of qualified mortgage bonds. For example, amounts paid for FHA, VA, or similar private mortgage insurance on an individual's mortgage need not be taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not

financial with qualified mortgage bonds. Premiums charged for pool mortgage insurance will be considered amounts in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds.

(D)(*1*) Where amounts other than those derived from the proceeds of a mortgage subsidy bond are used to finance single-family residences such amounts will not be treated as the proceeds of a qualified mortgage bond issue and will not be subject to the limitations set forth in subparagraphs (2), (3), and (4) of this paragraph (i). Such amounts may, however, be treated as proceeds for purposes of the requirements of section 103(c) and the regulations thereunder. Thus, the portion of the mortgage pool financed by the proceeds of a qualified mortgage bond issue will be subject to the limitations of subparagraphs (2), (3), and (4) of this paragraph (i), while the portion not provided with bond proceeds will not be subject to such limitations. The interest rate, points, origination fees, servicing fees, and other amounts charged with respect to that portion of a mortgage loan financed with non-bond amounts may not exceed the reasonable and customary amount which would be charged where financing is not provided through a qualified mortgage bond issue. Where the charge does exceed such reasonable and customary amount, any excess will be taken into account in computing the effective interest rate on the portion of the loan provided with the proceeds of the qualified mortgage bond issue. Furthermore, where such fees and other charges are less than the reasonable and customary charges, the issuer may not allocate that portion of the charges on the loan amounts made with bond proceeds which is equal to such differential to loan amounts made with non-bond proceeds.

(*2*) If any mortgage is allocated to two or more sources of funds, the receipt of amounts which are described in paragraph (i)(2)(ii) (A) and (B) of this section, repayments of principal, or payments of interest on such mortgage must be allocated to each source of funds.

(E) The effective rate of interest on any mortgage shall be determined in a manner consistent with actuarial methods and shall take into account the discounted value of all amounts from the time received to an amount equal to the ''purchase price'' of the mortgage. Such discount rate is the effective rate of interest on the mortgages. The ''purchase price'' of a mortgage means the net amount loaned to the mortgagor. For example, if a mortgage loan is in the amount of $30,000 and the mortgagor is charged one point ($300) as an origination fee which amount is deducted from loan proceeds available to the mortgagor, the purchase price is $29,700. If interest on an issue is paid semiannually, all regular monthly mortgage payments and prepayments of principal may be treated as being received at the end of each semiannual debt service period.

(*1*) If interest on an issue is paid semiannually, all regular monthly mortgage payments may be treated as being received at the end of each semiannual debt service period.

(*2*) Prepayments of principal shall be treated as being received on the last day of the month in which the issuer reasonably expects to receive such prepayments.

(F) The rate shall be determined on a composite basis for all mortgages financed by the issue.

(iii) *Example.* The following example illustrate the provisions of subparagraph (2)(ii) of this paragraph:

Example. Purchaser A contracts with seller B, who is represented by real estate agent C, for the purchase of B's residence for $65,000. A applies to County X for a mortgage provided by the proceeds of a qualified mortgage bond. County X requires that agent C provide it with a principal residence affidavit as well as verify the purchase price of the residence and the location of the purchasers previous residences. Due to the increased administrative burden imposed on agent C by County X, C charges B a real estate commission of 8 percent ($5,200), rather than 6 percent ($3,900). The normal real estate commission is 6 percent. Since the 8 percent commission charged by C and paid by B is in excess of the usual and reasonable real estate commission where owner financing is not provided through the use of qualified mortgage bonds, 2 percent ($1,300) shall be treated

as borne by A and taken into account in calculating the effective rate of interest on the mortgage.

(iv) *Prepayment assumption* In determining the affective rate of interest on mortgages, it shall be assumed that the mortagage prepayment rate for mortgages made out of both original proceeds and mortgages that the issuer expects with reasonable certainty to be made out of prepayments of principal will be equal to 100 percent of the rate set forth in the most recent mortgage maturity experience table for mortgages having the same term insured under section 203 of the National Housing Act and published by the Federal Housing Administration in ''Survivorship and Decrement Tables for HUD/FHA Home MORTGAGE Insurance Program'' for the region, or, if available, the State in which the residence is located. For purposes of applying these tables, either the original balance method or the declining balance method of calculating mortgage loan prepayments may be used. For proceeds used to finance qualified home improvement loans or shorter term qualified rehabilitation loans for which there are no comparable FHA mortgage maturity experience tables, the assumption used by the issuer as to the rate of prepayment shall be based upon the reasonable expectations of the issuer, as reflected, where applicable, by the issuer's prior experience with such loans.

(v) *Net losses.* The projected net losses on the mortgage pool (after foreclosure and payment of insurance proceeds), based on the most recent default experience for the area in which the residences are located, shall be taken into consideration in calculating the effective rate of interest on the mortgages. However, where mortgages provided under an issue are insured with FHA, VA, or private mortgage insurance, in conjunction with pool mortgage insurance, the expected net losses will be presumed to be zero. In the event that the actual losses on the mortgage pool exceed the projected net losses which were taken into consideration in calculating the effective rate of interest on the mortgages, investment proceeds earned from nonmortgage assets may be used to recover the excess losses and need not be paid or credited to the mortgagors under § 6a.103A–2(i)(4).

(vi) *Yield on the issue.* (A) The yield on an issue of qualified mortgage bonds shall be calculated on the basis of—

(*1*) The issue price, and

(*2*) An expected maturity for the bonds which is consistent with the prepayment assumption required under subparagraph (2)(iv) of this paragraph.

The expected maturity will be considered consistent with such prepayment assumption if all prepayments are assumed to be used to call bonds proportionately (*i.e.*, a ''strip'' call). The preceding sentence shall not apply to prepayments of mortgages provided from original proceeds to the extent such prepayments are used to provide mortgages.

(B) For purposes of (*1*) of this subdivision (vi), the term ''issue price'' shall have the same meaning as in section 1232(b)(2). Thus, in general, such term means the initial offering price to the public, not including bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers, at which price a substantial amount of such obligations were sold or, if privately placed, the price paid by the first buyer of such obligations or the acquisition cost of the first buyer.

(3) *Nonmortgage investments*—(i) *Maximum investment.* Except as provided in subdivision (ii) of this subparagraph, an issue meets the requirements of this subparagraph only if—

(A) At no time during any bond year does the aggregate amount invested in nonmortgage investments, *e.g.*, reasonably required reserve funds, with a yield materially higher than the yield on the issue exceed 150 percent of the debt service on the issue for the current bond year, and

(B) Such aggregate amount invested in nonmortgage assets with a yield materially higher than the yield on the issue is promptly and appropriately reduced as mortgages are repaid.

The amount subject to the maximum investment rule in subdivision (i)(A) of this subparagraph includes the original bond proceeds, investment proceeds and repayments of principal on the mortgages. For purposes of subdivision

(B), the amount described in subdivision (A) shall be considered promptly and appropriately reduced if beginning in the first bond year after the expiration of the temporary period for original proceeds described in subdivision (ii)(A) of this subparagraph, such amount is reduced within 30 days of the beginning of each bond year by an amount equal to the difference between the average scheduled monthly mortgage receipts for the bond year (excluding any receipts that were scheduled with respect to mortgages that were discharged in the preceding bond year) and the average scheduled monthly mortgage receipts for the preceding bond year.

(ii) *Temporary periods.* Subparagraph (3)(i) of this paragraph shall not apply to—

(A) Proceeds (including prepayments of principal designated to be used to acquire additional mortgages) of the issue invested for an initial temporary period not to exceed 1 year (1½ years for proceeds required to be set aside for placing mortgages in targeted areas) until such proceeds are needed for mortgages, and

(B) Repayments of principal and interest on mortgages that are contributed to a bona fide debt service fund (as defined in §1.103–13(b)(12)) and invested for a 13-month temporary period as provided in §1.103–14(b)(10).

(iii) *Debt service defined.* For purposes of subparagraph (3)(i)(A) of this paragraph, the debt service on the issue for any bond year is the scheduled amount of interest and amortization of principal payable for such year with respect to such issue. There shall not be taken into account amounts scheduled with respect to any bond which has been retired before the beginning of the bond year.

(iv) *Nonmortgage investments.* A nonmortgage investment is any investment other than an investment in a qualified mortgage. For example, a mortgage-secured certificate or obligation is a nonmortgage investment. Investment earnings from participation fees (described in §6a.103A–1(b)(5)) are treated as investment proceeds on nonmortgage investments unless such fees are used to pay debt service or to finance owner occupied residences.

(v) *Bonds issued after June 30, 1993.* Section 1.148–2(f)(2)(iv) applies to bonds issued after June 30, 1993, in lieu of this paragraph (i)(3).

(4) *Arbitrage and investment gains to be used to reduce costs of owner financing*—(i) *Rebate requirement.* An issue shall be treated as meeting the requirements of this subparagraph only if an amount equal to the sum of:

(A) The excess of—

(*1*) The net amount earned on all nonmortgage investments pursuant to subparagraph (3)(i) and (ii) of this paragraph (other than investments attributable to an excess described in this subdivision (A)) over

(*2*) The amount which would have been earned if the investments were invested at a rate equal to the yield on the issue, plus

(B) Any income attributable to the excess described in subdivision (A),—

shall be paid or credited to the mortgagors as rapidly as practicable. Such amount may be disproportionately distributed to the mortgagors if the larger portion of such amount is distributed to lower income mortgagors. The determination of the excess described in subdivision (A) shall take into account any reinvestment of nonmortgage investment receipts and any gain or loss realized on the disposition of nonmortgage investments. In addition, where nonmortgage investments are retained by the issuer after retirement of an issue, any unrealized gains or losses as of the date of retirement of such issue must be taken into account, in calculating the amount to be rebated to the mortgagors. The amount described in subdivision (A)(*2*) is the amount that would have been earned if the investments in nonmortgage obligations were invested at a rate equal to the yield on the issue calculated in the same manner as provided in §6a.103A–2(i)(2)(vi) and by using the same compounding method. For purposes of subdivision (B), any income attributable to the excess described in subdivision (A) shall be taken into account whether or not such income exceeds the yield on the bonds.

(ii) *Computation period.* Whether earnings are amounts described in subdivision (i) (A) or (B) of this subparagraph

shall be determined by making computations on an annual basis. For example, if at the end of the first year the earnings on nonmortgage investments exceed the amount that could have been earned if such investments were invested at the bond yield, the amount of earnings equal to such difference constitutes an excess described in subdivision (i)(A) of this subparagraph. In the following year, investment proceeds earned on such excess must be taken into account, whether or not such earnings exceed the yield on the bonds, and may not be treated as ''negative arbitrage''.

(iii) *Paid or credited.* For purposes of subdivision (i) of this subparagraph, amounts are paid or credited to mortgagors as rapidly as practicable if such amounts are paid or credited to such mortgagors at the time the mortgagor discharges the mortgage, for example, through prepayment of the entire principal amount or through making the last regular payment on the mortgage. The amount paid or credited to the mortgagors must have a present value at least equal to the present value of the amount described in subdivision (i) of this subparagraph, using the yield on the bonds as the discount rate. In the case of prepayments, the cumulative amount required to be rebated under subparagraph (4)(i) of this paragraph may be determined as of a date before the actual prepayment but not more than 1 year earlier than the date of prepayment. Except as provided in subparagraph (2)(v) or subparagraph (4)(iv) of this paragraph, such amount may not be subject to the claim of any party, *e.g.*, a bondholder, and may not be paid over to any party other than the mortgagor or the United States.

(iv) *Reduction where issuer does not use full 1 percentage point.* (A) The amount required to be paid or credited to mortgagors under subparagraph (4)(i) of this paragraph shall be reduced by the amount which (if it were treated as an interest payment made by mortgagors) would result in the excess referred to in subparagraph (2)(i) of this paragraph being equal to 1 percentage point. Such amount shall be fixed and determined as of the yield determination date. This fixed dollar amount may be received by the issuer at any time but may not be adjusted for the time of payment. Such fixed dollar amount shall be equal to the difference between the purchase price of mortgages financed by the proceeds of the issue and the present value of expected payments of principal and interest on such mortgages, using a discount rate equal to the bond yield plus 1 percentage point.

(B) The following example illustrates the provisions of subparagraph (4)(iv)(A) of this paragraph:

Example. In 1981, County X issues obligations to provide mortgages for owner-occupied residences. The yield paid on the obligations is 10 percent, and the effective rate of interest on the mortgages provided by the proceeds of such obligations is 9.75 percent. X maintains a reasonably required reserve fund which is invested at 15 percent and intends to recover that additional amount computed in the manner described in subparagraph (4)(iv) which could have been earned from investment of the proceeds in mortgages with an effective interest rate of 11 percent from the arbitrage earned from the reserve fund nonmortgage assets. X plans to recover such amount from the arbitrage over a period of 3 years; thus, X will not recover such amount until 1984. X may not adjust the amount to be received to account for the time when such amount will be received.

(v) *Election to pay United States.* Subparagraph (4)(i) of this paragraph shall be satisfied with respect to any issue if the issuer elects in writing before issuing the obligations to pay over to the United States—

(A) Not less frequently than once each 5 years after the date of issue, an amount equal to 90 percent of the aggregate amount described in subdivision (i) earned during such period (and not theretofore paid to the United States), and

(B) Not later than 30 days after the redemption of the last obligation, 100 percent of such aggregate amount not theretofore paid to the United States.

(j) *New mortgages*—(1) *In general.* An issue meets the requirements of this paragraph only if no part of the proceeds of such issue is to be used to acquire or replace an existing mortgage. All of the lendable proceeds must be used to provide mortgage loans to persons who did not have a mortgage (whether or not paid off) on the residence securing the mortgage note at

any time prior to the execution of the mortgage.

(2) *Exceptions.* For purposes of this paragraph, the replacement of—

(i) Construction period loans,

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

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

shall not be treated as the acquisition or replacement of an existing mortgage. Generally, temporary initial financing is any financing which has a term of 24 months or less.

(3) *Assumptions.* An issue meets the requirement of this paragraph only if a mortgage with respect to which owner financing has been provided under such issue may be assumed only if the requirements of paragraphs (d), (e), and (f) of this section are met with respect to such assumption. The determination of whether these requirements are met is based upon the facts as they exist at the time of the assumption as if the loan were being made for the first time. For example, the purchase price requirement is to be determined by reference to the average area purchase price at the time of the assumption and not when the mortgage was originally placed. If the bond documents and relevant mortgage instruments provide that a mortgage may be assumed only if the issuer has determined that the conditions stated in this subparagraph are satisfied, the good faith and 95-percent requirements of paragraph (c)(1)(i) and (ii) of this section will be considered satisfied with respect to the requirements of this subparagraph at the time the mortgages were executed. However, any failure to meet the requirements of this subparagraph at the time a mortgage is assumed is subject to the remedy requirement in paragraph (c)(1)(iii) of this section.

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

Example (1). In June 1981 mortgagor A obtained a mortgage from a private lending institution in order to construct a house on land which A purchased without a mortgage in May 1981. In January 1982 A applies to obtain permanent financing on the residence from a program sponsored by State housing finance agency Y. Such program is funded with the proceeds of qualified mortgage bonds. If A meets the other requirements of this section, A qualifies for such permanent financing since the replacing of construction financing is not treated as the acquisition or replacement of an existing mortgage.

Example (2). In June 1981 mortgagor B purchased a new residence in a targeted area but was unable to sell his former residence. Therefore, B obtained temporary financing for his new residence until his former residence was sold. In October 1981 B applies to County Z to obtain financing from a program funded with proceeds of qualified mortgage bonds. Such financing is needed by B to replace the temporary financing for his new residence. If B meets the other requirements of this section, the mortgage qualifies for such permanent financing since the permanent financing replaces temporary initial financing.

Example (3). In 1979 mortgagor C purchased a residence but was unable to obtain financing from a program sponsored by County W because such program prohibited loans from the program which were in excess of 80 percent of the fair market value of the property. Therefore, in 1979 C obtained financing from a private lending institution with the intention of refinancing when he accumulated sufficient equity in the property. In 1981 C has accumulated sufficient equity in the property so as to comply with the requirements of the program. C applies to County W to refinance under the program, which is funded with the proceeds of qualified mortgage bonds. Even if C met the other requirements of this section, the mortgage would fail to meet the requirement of paragraph (j) since such a mortgage would replace an existing mortgage.

Example (4). In 1969 mortgagor D purchased a residence and obtained financing from a private lending institution. In 1981 D applies to County U for a loan for the rehabilitation of the property and for the refinancing of the existing mortgage. The program is funded with qualified mortgage bonds. If D meets the other requirements of this section the mortgage qualifies for such permanent financing since the replacement of the mortgage is not treated as the replacement or acquisition of an existing mortgage.

Example (5). In 1950 mortgagor E purchased a residence, obtaining a mortgage from a private lending institution to finance the purchase price. In 1980 E completed repaying the mortgage. In 1981 E applies for a loan from a program sponsored by State housing finance agency X and funded with the proceeds of qualified mortgage bonds. The mortgage does not meet the requirements of paragraph (j) since E had a previous mortgage on his residence, even though such mortgage was previously released.

(k) *Information reporting requirement.* See § 1.103A–2(k) for rules relating to section 103A(j)(3).

(l) *Policy statement.* See § 1.103A–2(l) for rules relating to section 103A(j)(5).

(m) *State certification.* See § 1.103A–2(m) for rules relating to section 103A(j)(4).

(98 Stat. 901 (26 U.S.C. 103A(j) (3) and (4)); 68A Stat. 917 (26 U.S.C. 7805))

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§ 6a.103A–3 Qualified veterans' mortgage bonds.

(a) *In general.* A qualified veterans' mortgage bond shall not be treated as a mortgage subsidy bond, and the interest shall be exempt from Federal income taxation.

(b) *Qualified veterans' mortgage bond.* (1) With respect to obligations issued prior to July 19, 1984, the term ''qualified veterans' mortgage bond'' means any issue of obligations—

(i) Which meets the requirements of § 6a.103A–1, § 6a.103A–2(j) (1) and (2), and this section;

(ii) Substantially all of the proceeds of which are to be used to provide financing for single-family, owner-occupied residences (which meet the requirements of § 6a.103A–1(b)(6) and § 6a.103A–2(d)) for veterans; and

(iii) Payment of the principal and interest on which is secured by a pledge of the full faith and credit of the issuing State.

A qualified veterans' mortgage bond does not include any bond that is an industrial development bond under section 103(b).

(2) With respect to obligations issued after July 18, 1984, the term ''qualified veterans' mortgage bond'' means any issue of obligations—

(i) Which meets the requirements of § 6.103A–1, § 6a.103A–2(d) (relating to residence requirements), (j) (1) and (2) (relating to new mortgage requirement), and (k) (relating to information reporting requirement), and this section;

(ii) Substantially all of the proceeds of which are to be used to provide financing for qualified veterans; and

(iii) Payment of the principal and interest on which is secured by a pledge of the full faith and credit of the issuing State.

A qualified veterans' mortgage bond does not include any bond that is an industrial development bond under section 103(b).

(c) *Qualified veteran.* (1) An issue meets the requirements of this paragraph only if each of the mortgagors to whom owner financing is provided is a qualified veteran.

(2) With respect to obligations issued prior to July 19, 1984, the term ''qualified veteran'' means any veteran.

(3) With respect to obligations issued after July 18, 1984, the term ''qualified veteran'' means any veteran who—

(i) Served on active duty at some time before January 1, 1977, and

(ii) Applied for financing before the later of—

(A) The date 30 years after the date on which such veteran left active service, or

(B) January 1, 1985.

(4) The term ''veteran'' shall have the same meaning as in 38 U.S.C. 101(2), that is, a person who served in the active military, naval, or air service, and who was discharged or released therefrom under conditions other than dishonorable.

(d) *Husband and wife.* For purposes of this section, if a residence is to be owned by a husband and wife as joint tenants, as tenants by the entirety, or as community property, and if one spouse is a veteran, then both spouses shall be treated as satisfying the requirements of paragraph (c) of this section.

(e) *Substantially all.* For purposes of this section, the term ''substantially all'' shall have the same meaning as in § 1.103–8.

(f) *Qualified home improvement loan.* The term ''qualified home improvement loan'' means the financing (whether or not secured by a mortgage) of alterations, repairs, and improvements on, or in connection with, an existing single-family, owner-occupied residence by a veteran who is the owner thereof. The alterations, repairs, and improvements, however, must substantially protect or improve the basic livability or energy efficiency of the

property, such as the renovation of plumbing or electric systems, the installation of improved heating or air conditioning systems, the addition of living space, or the renovation of a kitchen area. Items that will not be considered to substantially protect or improve the basic livability of the property include swimming pools, tennis courts, saunas, or other recreational or entertainment facilities.

(g) *Volume limitation*—(1) *In general.* In the case of obligations issued after June 22, 1984, an issue meets the requirements of this paragraph only if the aggregate amount of obligations issued pursuant thereto, when added to the aggregate amount of qualified veterans' mortgage bonds previously issued by the State during the calendar year, does not exceed the State veterans limit for such calendar year. In determining the aggregate amount of qualified veterans' mortgage bonds issued in calendar year 1984, obligations issued prior to June 23, 1984, shall not be taken into account.

(2) *State veterans limit.* (i) The State veterans limit for any State is the amount equal to—

(A) The aggregate amount of qualified veterans' mortgage bonds issued by the State during the period beginning on January 1, 1979, and ending on June 22, 1984 (not including the amount of any qualified veterans' mortgage bonds actually issued during the calendar year, or the applicable portion of 1984, in such period for which the amount of such bonds was the lowest), divided by

(B) The number (not to exceed 5) of calendar years after 1978 and before 1985 during which the State issued qualified veterans' mortgage bonds.

In determining the number of calendar years after 1978 and before 1985 during which the State issued qualified veterans' mortgage bonds, any qualified veterans' mortgage bonds issued after June 22, 1984, shall not be taken into account. A State that did not issue qualified veterans' mortgage bonds during the period beginning on January 1, 1979, and ending on June 22, 1984, may not issue qualified veterans' mortgage bonds after June 22, 1984.

(ii) In the case of any obligation which has a term of 1 year or less and which was issued to provide financing for property taxes, the amount taken into account under this paragraph with respect to such obligation shall be 1/15 of its principal amount.

(3) *Examples.* The following examples illustrate the provisions of this paragraph:

Example (1). State R issued the following issues of qualified veterans' mortgage bonds: a $200 million issue on March 31, 1979, a $150 million issue on May 1, 1980, a $75 million issue on September 1, 1981, a $200 million issue on June 5, 1982, a $125 million issue on March 1, 1983, a $60 million issue on April 1, 1984, and a $100 million issue on September 1, 1984. R issued no other issues of qualified veterans' mortgage bonds during the period beginning January 1, 1979, and ending on December 31, 1984. The aggregate amount of qualified veterans' mortgage bonds issued during the period January 1, 1984, through June 22, 1984 ($60 million), is not taken into account in determining R's State veterans limit because that is the lowest aggregate amount of qualified veterans' mortgage bonds issued during the calendar year or the applicable portion of 1984, in the period beginning on January 1, 1979, and ending on June 22, 1984. Thus, R's State veterans limit is $150 million ($750 million (which is the sum of $200 million, $150 million, $75 million, $200 million, and $125 million) divided by 5). The September 1, 1984, issue is not included in determinig the State veterans limit because that issue was issued after June 22, 1984. The September 1, 1984, issue of qualified veterans' mortgage bonds meets the requirements of §6a. 103A–3 (g) since the aggregate amount of qualified veterans' mortgage bonds issued in calendar year 1984 (not including obligations issued prior to June 23, 1984), does not exceed the State veterans limit.

Example (2). State S issued a $100 million issue of qualified veterans' mortgage bonds on March 31, 1984. S issued no other issues of qualified veterans' mortgage bonds during the period beginning on January 1, 1979, and ending on June 22, 1984. The aggregate amount of qualified veterans' mortgage bonds issued in the calendar year, or the applicable portion of 1984, in the period January 1, 1979, through June 22, 1984, for which the amount of bonds was the lowest is zero. Thus, the State veterans limit for S is $100 million (($100 million minus $0) divided by 1).

(h) *Good faith compliance efforts*—(1) *Mortgage eligibility requirements.* An issue of qualified veterans' mortgage bonds issued after July 18, 1984, which fails to meet the requirements of section 103A(o)(1), §6a.103A–2(d) relating to residence requirements), and §6a.103A–2(j) (1) and (2) (relating to new

mortgage requirements) shall be treated as meeting such requirements if each of the following provisions is complied with:

(i) The issuer in good faith attempted to meet all such requirements before the mortgages were executed. Good faith requires that the trust indenture, participation agreements with loan originators, and other relevant instruments contain restrictions that permit the financing of residences only in accordance with such requirements. In addition, the issuer must establish reasonable procedures to ensure compliance with such requirements. Such procedures include reasonable investigations by the issuer to satisfy such requirements.

(ii) Ninety-five percent or more of the lendable proceeds (as defined in § 6a.103A–2(b)(1)) that were devoted to owner-financing were devoted to residences with respect to which, at the time the mortgages were executed, all such requirements were met. In determining whether a person is a qualified veteran the issuer may rely on copies of the mortgagor's certificate of discharge indicating that the mortgagor served on active duty at some time before January 1, 1977, and stating the date on which the mortgagor left active service provided that neither the issuer nor its agent knows or has reason to believe that such affidavit is false. Where a particular mortgage fails to meet more than one of these requirements, the amount of the mortgage will be taken into account only once in determining whether the 95-percent requirement is met. However, all of the defects in the mortgage must be corrected pursuant to subdivision (iii).

(iii) Any failure to meet such requirements is corrected within a reasonable period after such failure is discovered. For example, failures can be corrected by calling the nonqualifying mortgage or by replacing the nonqualifying mortgage with a qualifying mortgage.

(2) *Nonmortgage eligibility requirements.* An issue of qualified veterans' mortgage bonds issued after July 18, 1984, which fails to meet the requirements of paragraph (g) of this section shall be treated as meeting such requirements if each of the requirements of § 6a.103A–2(c)(2) (i) and (ii) is met.

(98 Stat. 901(26 U.S.C. 103A(j) (3) and (4)); 68A Stat. 917 (26 U.S.C. 7805))

[T.D. 7780, 46 FR 34314, July 1, 1981; 46 FR 37890, July 23, 1981, as amended by T.D. 7995, 49 FR 48297, Dec. 12, 1984]

§ 6a.6652(g)–1 Failure to make return or furnish statement required under section 6039C.

(a) *Amount imposed.* In the case of each failure to meet the requirements of—

(1) Section 6039C, relating to information returns with respect to United States real property interests, or

(2) Section 6039C(b)(3), relating to statements to be provided to substantial investors in United States real property interests,

on or before the date prescribed therefor (determined with regard to any extension of time for filing), the person failing to meet such requirement shall pay $25 for each day during which such failure continues.

(b) *Limitation*—(1) *Domestic corporations and nominees.* The maximum penalty which may be imposed under paragraph (a) of this section on a domestic corporation or nominee for failure to meet the requirements of section 6039C(a) for any calendar year is $25,000.

(2) *Partnerships, trusts, estates and foreign corporations.* The maximum penalty which may be imposed on a partnership, trust, estate or foreign corporation for failure to meet the requirements of section 6039C(b) for any calendar year is $25,000.

(3) *Foreign persons holding U.S. real property interests and nominees.* The maximum penalty which may be imposed on a foreign person holding a U.S. real property interest or on a nominee holding a U.S. real property interest for a foreign person for failure to meet the requirements of section 6039C(c) for any calendar year is the lesser of $25,000 or 5 percent of the aggregate of the fair market value of the U.S. real property interests owned by such person at any time during such calendar year.

(c) *Definitions*—(1) *Fair market value.* The term ''fair market value'' as used in this section is defined in § 6a.897–1

(in the FEDERAL REGISTER 47 FR 41541, Sept. 21, 1982).

(2) *Failure.* The term ''failure to meet the requirements of section 6039C'' includes the failure to file a return for any calendar year on the date prescribed therefor (determined with regard to any extension of time for such filing), or the omission on a return of one or more items of information required by section 6039C and the regulations thereunder to be provided on the return. It also includes the failure to furnish a statement required by section 6039C(b)(3). The failure to furnish a return required under section 6039C(b)(1) and the failure to furnish a statement to a substantial investor as required by section 6039C(b)(3), are separate failures for purposes of paragraph (a) of this section. Also, each failure to provide a statement to each substantial investor is a separate failure for purposes of paragraph (a). Thus, if an entity has 100 substantial investors as defined in section 6039C and fails to furnish any of the required statements to substantial investors, there are 100 separate failures to furnish the required statement.

(3) *Aggregate of the fair market value of the United States real property interests.* The ''aggregate of the fair market value of the U.S. real property interests'' is the total of the fair market values of each U.S. real property interest owned at any time during the calendar year. Fair market value is determined as of December 31 of such year for property held at the end of the year and on the date of disposition for property disposed of during the year.

(d) *Attribution of ownership.* For purposes of calculating the penalty limitation under § 6a.6652(g)–1(b)(3) with respect to failure to meet the requirements of section 6039C(c), U.S. real property interests held by a partnership, trust, or estate shall be treated as owned proportionately by its partners or beneficiaries.

(e) *Exceptions*—(1) *Provision of security.* If a person otherwise required by section 6039C to file a return for a calendar year or furnish a statement to a substantial investor complies with the requirements of § 6a.6039C–5 relating to furnishing security in lieu of filing such return, or is exempt, by virtue of § 6a.6039C–5(f), from filing a return for such year with respect to its U.S. real property interests held, no penalty will be imposed under paragraph (a) of this section for failure to file such return or furnish such statement.

(2) *Showing of reasonable cause.* No amount shall be imposed under paragraph (a) of this section for a failure described in such paragraph if it is established to the satisfaction of the Director of the Internal Revenue Service Center, 11601 Roosevelt Boulevard, Philadelphia, Pennsylvania 19155 or in the case of returns concerning the Virgin Islands, the Commissioner of the Bureau of Internal Revenue, Tax Division, Charlotte Amalie, St. Thomas, V.I. 00801, that such failure is due to reasonable cause and not to willful neglect. An affirmative showing of reasonable cause must be made in the form of a written statement, made under the penalties of perjury, containing a declaration by the person failing to make a return or furnish a statement under section 6039C setting forth all the facts alleged as reasonable cause. Whether reasonable cause is shown may depend upon the subsection of section 6039C under which the failure occurs. However, the fact that stock of a foreign corporation, or any other interest in any entity to which this section applies, is registered in bearer form does not constitute reasonable cause under this paragraph (e)(2) of this section for failure to comply with the requirements of section 6039C(b). Also, the fact that disclosure of ownership would contravene a secrecy law of any country does not constitute reasonable cause for failure to comply with the requirements of section 6039C(b). Where a return has been filed and there is an omission of one or more items of information required by section 6039C and the regulations thereunder, one of the facts to be considered in determining whether such failure is due to reasonable cause is the materiality of the item omitted.

(3) *Spouse or parent already filed with respect to same property.* If an individual files a return with respect to all U.S. real property interests held by such individual in accordance with § 6a.6039C–4(b), no penalty shall be imposed under this section on such individual's spouse

or minor child for failure to file a return under § 6a.6039C–4 with respect to the same property.

(f) *Manner of payment.* The amount imposed under paragraph (a) of this section on any person shall be paid in the same manner as tax upon the issuance of a notice and demand therefor.

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

Example (1). Domestic corporation X is required under section 6039C (a) to make a return for calendar year 1982. X does not file such return on or before May 15, 1983 as required under § 6a.6039C–1(c). The failure to file the return for calendar year 1982 continues throughout calendar years 1983, 1984, 1985, and 1986. The failure to file is not due to reasonable cause and no security has been furnished in lieu of filing. The maximum penalty which can be imposed on X for failure to file the 1982 return is $25,000, determined as follows:

	Penalty incurred in given year	Cumulative penalty for failure to file 1982 return
Total penalty incurred in 1983 ($25 per day × 230 days)	$5,750	$5,750
Total penalty incurred in 1984 (a leap year): ($25 per day × 366 days)	9,150	14,900
Total penalty incurred in 1985 ($25 per day × 365 days)	9,125	24,025
Total penalty incurred in 1986 (lesser of $25 per day × 365 days or $975 (remaining penalty which may be imposed))	975	25,000

Example (2). The facts are the same as in example (1) except that X also fails to file a return under section 6039C (a) for calendar year 1983. The failure to file its return for calendar year 1983 continues throughout calendar years 1984, 1985, 1986 and 1987. The total penalty which may be imposed on X for failure to file its return for calendar year 1983 is $25,000. The amount of penalty which can be imposed on X in calendar years 1984, 1985, 1986 and 1987 is determined as follows:

	Penalty for 1982 failure	Penalty for 1983 failure	Total penalty for given year
Penalty incurred in 1984 (a leap year):			
For failure to file 1982 return ($25 per day × 366 days)	$9,150	.....	.....
For failure to file 1983 return ($25 per day × 230 days)	.....	$5,750	.....
Total	.....	.....	$14,900
Penalty incurred in 1985:			
For failure to file 1982 return ($25 per day × 365 days)	9,125	.....	.....
For failure to file 1983 return ($25 per day × 365 days)	.....	9,125	.....
Total	.....	.....	18,250
Penalty incurred in 1986:			
For failure to file 1982 return (lesser of $25 per day × 365 days or $975 (remaining penalty which may be imposed))	975	.....	.....
For failure to file 1983 return ($25 per day × 365 days)	.....	9,125	.....
Total	.....	.....	10,100
Penalty incurred in 1987:			
For failure to file 1983 return (lesser of $25 per day × 365 days or $1,000 (remaining penalty which may be imposed))		1,000	.....
Total	.....	.....	1,000

Example (3). Foreign corporation Y is required under section 6039C(b)(1) to make a return for calendar year 1982. In addition, Y is required under section 6039C(b)(3) to furnish statements to each substantial investor in U.S. real property interests. Y has 10 such substantial investors. Y does not file such return on or before May 15, 1983 as required under § 6a.6039C–1(c), nor does it furnish the required statements on or before January 31, 1983 as required under § 6a.6039C–3(h). The failure to file the return for calendar year 1982 and to furnish the required statements for 1982 continues throughout calendar years 1984 and 1985. The failure to meet the requirements of section 6039C(b) are not due to reasonable cause and no security has been furnished in lieu of filing. The total penalty which can be imposed on Y for failure to file the return and statements required under section 6039C(b) for calendar year 1982 is $25,000. The amount of penalty incurred by Y in calendar year 1983 for failure to file the return and statements for calendar year 1982 is $25,000, determined as follows:

Penalty incurred in 1982:	
For failure to file return ($25 per day×230 days)	$5,750
For each failure to furnish a statement required by section 6039C(b)(3) ($25 per day×10 statements×the 334 days from February 1, 1983 to December 31, 1983 ($83,500) but not more than $19,250 (which when added to $5,750 would total $25,000))	19,250
Total	25,000

Since Y has incurred the maximum penalty for failure to file its return and statements required for 1982 by the end of calendar year 1983, no further penalty for these failures is imposed.

Example (4). Under section 6039C(c) foreign person Y is required to make a return for calendar year 1982. Y does not file such return on May 15, 1983 and the failure is not due to reasonable cause. No security has been furnished in lieu of filing. All properties owned by Y in 1982 are U.S. real property interests. Y purchased property M in January 1982 when its fair market value was $10,000. In March, Y purchased property N when its fair market value was $15,000. In November, Y sold property M for $20,000. The fair market value of property N on December 31, 1982, was $20,000. The total of the fair market values of M and N (M as of the date of its sale and N as of December 31, 1982) is $40,000. The maximum penalty which may be imposed on Y for failure to meet the requirements of section 6093C(c) for any calendar year is the lesser of $25,000 or 5 percent of the aggregate of the fair market values of the U.S. real property interests owned by Y at any time during such calendar year. Since $2,000 (5 percent of $40,000) is less than $5,750 ($25 times 230 days, the number of days in calendar year 1983 for which the failure continues), the maximum penalty which may be imposed on Y in 1983 is $2,000. Since the maximum penalty for the failure to file the 1982 return is incurred in 1983, no amount may be imposed for Y's continuing failure to file the return for calendar year 1982 during calendar years after 1983.

(h) Effective date. This section shall apply to 1980 and subsequent calendar years. The calendar year 1980 shall be treated as beginning on June 19, 1980 and ending on December 31, 1980.

[T.D. 7866, 48 FR 648, Jan. 6, 1983]

PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Sec.

7.48–1 Election to have investment credit for movie and television films determined in accordance with previous litigation.
7.48–2 Election of forty-percent method of determining investment credit for movie and television films placed in service in a taxable year beginning before January 1, 1975.
7.48–3 Election to apply the amendments made by sections 804 (a) and (b) of the Tax Reform Act of 1976 to property described in section 50(a) of the Code.
7.57(d)–1 Election with respect to straight line recovery of intangibles.
7.105–1 Questions and answers relating to exclusions of certain disability income payments.
7.105–2 Substantial gainful activity.
7.367(b)–1 Other transfers.
7.367(b)–2 Definitions.
7.367(b)–3 Special rules.
7.367(b)–4 Certain exchanges described in more than one Code provision.
7.367(b)–5 Complete liquidation of foreign subsidiary.
7.367(b)–6 Exchange of stock in a foreign investment company.
7.367(b)–7 Exchange of stock described in section 354.
7.367(b)–8 Transfer of assets by a foreign corporation in an exchange described in section 351.
7.367(b)–9 Attribution of earnings and profits on an exchange described in section 351, 354, or 356.
7.367(b)–10 Distribution of stock described in section 355.
7.367(b)–11 Deficit in earnings and profits.
7.367(b)–12 Subsequent treatment of amounts attributed or included in income.
7.367(b)–13 Examples.
7.367(c)–1 Section 355 distribution treated as an exchange.
7.367(c)–2 Contribution of capital to controlled corporations.
7.465–1 Amounts at risk with respect to activities begun prior to effective date; in general.
7.465–2 Determination of amount at risk.
7.465–3 Allocation of loss for different taxable years.
7.465–4 Insufficient records.
7.465–5 Examples.
7.704–1 Partner's distributive share.
7.936–1 Qualified possession source investment income.
7.999–1 Computation of the international boycott factor.
7.6039A–1 Information regarding carryover basis property acquired from a decedent.
7.6041–1 Return of information as to payments of winnings from bingo, keno, and slot machines.

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

Section 7.367 (b)–1 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–2 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–3 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–4 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–5 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–6 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–7 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–8 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–9 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–10 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–11 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–12 also issued under 26 U.S.C. 367 (b).
Section 7.367 (b)–13 also issued under 26 U.S.C. 367 (b).

§ 7.48–1 Election to have investment credit for movie and television films determined in accordance with previous litigation.

(a) *Generally.* Under section 804(c)(3) of the Tax Reform Act of 1976 (Pub. L. 94–455, 90 Stat. 1595), any taxpayer who filed an action in any court of competent jurisdiction before January 1, 1976, for a determination of such taxpayer's rights to investment credit under section 38 of the Internal Revenue Code of 1954 with respect to any film placed in service in any taxable year beginning before January 1, 1975, may elect to have investment credit on all films placed in service in taxable years beginning before January 1, 1975, (except those subject to an election under section 804(e)(2) of the Act), determined as though section 804 of the Act (except section 804(c)(3) of the Act) had not been enacted.

(b) *Manner of making the election.* The election allowed by section 804(c)(3) of the Act may be made by a notification in the form of a letter signed by the taxpayer or an authorized representative of the taxpayer stating:

(1) The taxpayer's name, address, and identification number;

(2) The taxable years in which the films were placed in service with respect to which the election shall apply; and

(3) The court in which the litigation was commenced and information adequate to identify the particular litigation, for example, the names of the litigants, the date the suit was commenced, and the court case or docket number of the litigation.

The letter should be sent to the Deputy Commissioner of Internal Revenue, Attention: CC:RL:Br2, Room 4617, 1111 Constitution Avenue, N.W., Washington, DC 20224.

(c) *Time for making the election.* The election under section 804(c)(3) of the Act must be made not later than January 3, 1977. If mailed, the cover containing the notification of such election must be postmarked not later than January 3, 1977.

(d) *Revocation of election.* An election under section 804(c)(3) of the Act, once made, shall be irrevocable.

[T.D. 7449, 41 FR 56629, Dec. 29, 1976]

§ 7.48–2 Election of forty-percent method of determining investment credit for movie and television films placed in service in a taxable year beginning before January 1, 1975.

(a) *General rule.* Under section 804(c)(2) of the Tax Reform Act of 1976 (90 Stat. 1595), taxpayers who placed movie or television films (here- inafter referred to as films and tapes) in service during taxable years beginning before January 1, 1975, may elect to have their investment credit on all such films and tapes determined under section 46(c) of the Code using an amount equal to 40 percent of aggregate production costs in lieu of the basis of such property. If the election is made, 100 percent is the applicable percentage used in determining qualified investment under section 46(c) of the Code regardless of actual useful life. The election can be made only with respect to qualified films and tapes that are new section 38 property and the investment credit is allowed only to the extent that a taxpayer has an ownership interest in the film or tape. No investment credit is allowed under section 804(c)(2) of the Act on any film or tape that is not section 38 property or that was produced and shown exclusively outside of the United States. Thus, no election

may be made under this section with respect to a film or tape which is suspension period property to which section 48(h) applies or to a film or tape which is termination period property to which section 49(a) applies. Any investment credit taken on any film or tape subject to the election is not subject to recapture because of an early disposition or because a film or tape otherwise ceases to be section 38 property under section 47(a) of the Code. Thus, there will be no recapture because a film or tape is used outside the United States under section 48(a)(2) of the Code or section 804(c)(1)(C) of the Act, or because of any disposition under section 47(a)(7)(B) of the Code.

(b) *Time and manner of making an election*—(1) *Time for making the election.* The election under section 804(c)(2) of the Act must be made not later than April 25, 1977.

(2) *Manner of making the election.* An election under this section must be made by filing amended income tax returns for each taxable year beginning before January 1, 1975, in which films and tapes subject to the election were placed in service, together with a statement signed by the taxpayer containing the information described below. The amended returns and the statement must be filed with the district director having audit jurisdiction over the last return filed to which the election relates. Each amended return shall contain a schedule listing by name all films and tapes placed in service during the year to which the amended return relates and setting forth all computations necessary to determine the aggregate production costs of each such film or tape listed and the ownership interest of the taxpayer in each film or tape listed. In the case of a taxpayer which is a partner, shareholder of an electing small business corporation, or beneficiary of a trust or estate, such computations must be adequate to determine the ownership interest of the partnership, electing small business corporation, or trust or estate in each such film or tape, (a taxpayer which is a partner, shareholder, or beneficiary may satisfy the requirements of the preceding sentence by attaching to his amended return a copy of an amended return, if one is filed, of the partnership, electing small business corporation, or trust or estate which sets forth computations necessary to determine the ownership interest of the entity in each such film or tape.) No amended return need be filed for a taxable year if application of the election to films and tapes placed in service during that year would not affect tax liability for any taxable year.

The statement shall contain the following information:

(i) The taxpayer's name and taxpayer identification number (under section 6109 of the Code).

(ii) A statement that the taxpayer is making the election under section 804(c)(2) of the Act.

(iii) A statement that the taxpayer agrees that the period for assessment and collection under section 6501 of the Code will remain open until December 31, 1978, solely with respect to adjustments of tax liability attributable to investment credit allowed on films and tapes placed in service in each year covered by the election. Unless the district director notifies the taxpayer within 7 days of receipt of the statement that such extension is denied, it will be presumed that the district director consents to such extension. Of course, the period covered by this statement may be extended beyond December 31, 1978 by mutual agreement. This statement does not shorten the regular statutory period for any year or take precedence over a previous or subsequent agreement with the Internal Revenue Service extending the statutory period for any year.

(iv) A list of the addresses used by the taxpayer on each return filed during each taxable year subject to the election.

(v) A statement that the taxpayer consents to join in judicial proceedings to determine the investment credit allowable and entitlement to investment credit on any film or tape subject to the election, which meets all of the requirements set forth in paragraph (b)(3) of this section.

(vi) A statement as to whether an election has been made by the taxpayer under section 804(e)(2) of the Act for films and tapes which are property described in section 50(a) of the Code

which were placed in service in taxable years beginning before January 1, 1975.

(vii) A list by name of all films or tapes placed in service during the years to which the election relates.

(viii) With respect to each film or tape listed in paragraph (b)(2)(vii) of this section, a list of all producers, distributors, and persons with a participation interest (with addresses where available).

(ix) In the case of an election made by a partner, shareholder of an electing small business corporation (as defined in section 1371(b) of the Code), or beneficiary, a statement indicating the name, taxpayer identification number, and address for tax return purposes of the respective partnership, electing small business corporation, or trust or estate.

(3) *Consent to join in judicial proceedings.* No election may be made by any taxpayer unless the statement made under paragraph (b)(2)(v) of this section provides that the taxpayer shall:

(i) Treat the determination of the investment credit allowable on each film or tape subject to an election as a separate cause of action;

(ii) Make all reasonable efforts necessary to join in or intervene in any judicial proceeding in any court for determining the person entitled to, and the amount of, the investment credit allowable with respect to any film or tape covered by the election after receiving notice from the Commissioner of Internal Revenue or his delegate indicating that a conflicting claim to the investment credit for such film or tape is being asserted in such court by another person; and

(iii) Consent to revocation of the election by the Commissioner of Internal Revenue or his delegate with respect to all films and tapes placed in service in taxable years for which the election applies, if the taxpayer fails to make all reasonable efforts necessary to join in or intervene in any judicial proceeding under paragraph (b)(3)(ii) of this section.

(4) *Who makes the election.* The election must be made separately by each person who has an ownership interest. However, where a film or tape is owned by a partnership, electing small business corporation (as defined in section 1371(b) of the Code), or trust or estate, the election must be made separately by each partner, shareholder or beneficiary. The election is not to be made by a partnership or electing small business corporation, and is to be made by a trust or estate only if the trust or estate in determining its tax liability would be allowed investment credit on a film or tape subject to the election. The election of any partner, shareholder, beneficiary or trust or estate shall be effective regardless of whether any related partner, shareholder, beneficiary, or trust or estate makes the election.

(5) *Additional time to perfect election.* A taxpayer that by April 25, 1977, files a statement containing the information described in paragraph (b)(2) (i) through (v) of this section shall be deemed to have made a timely election under paragraph (b)(2) of this section if by July 5, 1977, the taxpayer has complied with all of the requirements of paragraph (b)(2) of this section. If a taxpayer demonstrates to the satisfaction of the district director that it is unable to meet the July 5, 1977, date even though it has made a good faith effort to do so, the district director may at his discretion extend that date to no later than October 4, 1977, for that taxpayer. Requests for extensions of the July 5, 1977, date should be addressed to the district director with whom the statement was filed.

(c) *Revocation of election*—(1) *Revocation by taxpayer.* (i) Except as provided in paragraph (c)(1)(ii) of this section, an election made under section 804(c)(2) of the Act may not be revoked by a taxpayer unless consent to revoke the election is obtained from the Commissioner of Internal Revenue or his delegate. Application for consent to revoke the election will be accepted only if permanent regulations are issued which contain rules which may not reasonably have been anticipated by taxpayers at the time the election was made. Any permanent regulations will provide a reasonable period of time within which taxpayers will be permitted to apply for consent to revoke the election and will allow revocation (where revocation is not barred by the limitations on credit or refund inspection 6511 of the Code) in the event of a

determination by the Commissioner of Internal Revenue or his delegate that such permanent regulations contain provisions that may not reasonably have been anticipated by taxpayers at the time of making such election.

(ii) An election properly made under section 804(e)(2) of the Act, to have sections 48(k) and 47 (a)(7) of the Code apply to films and tapes which are property described in section 50(a) of the Code and which were placed in service in taxable years beginning before January 1, 1975, shall automatically revoke any election under section 804(c)(2) of the Act with respect to such films and tapes. Such revocation does not require the consent of the Commissioner of Internal Revenue or his delegate.

(2) *Revocation by Commissioner.* The Commissioner of Internal Revenue or his delegate shall revoke an election made under section 804(c)(2) of the Act if a taxpayer fails to make all reasonable efforts necessary to join in or intervene, in a judicial proceeding for determination of the person entitled to, and the amount of, the investment credit allowable with respect to any film or tape covered by the election after receiving notice from the Commissioner or his delegate which indicates that a conflicting claim to the investment credit for such film or tape is being asserted in court by another person.

(d) *Furnishing of supplementary information required.* If these regulations are revised to require the furnishing of information in addition to that which was furnished with the amended returns and statement of election filed pursuant to paragraph (b) (2) and (3) of this section, the taxpayer must furnish such additional information in a statement addressed to the district director with whom the amended return and statement of election were filed.

((68A Stat. 917; 26 U.S.C. 7804); sec. 804(c)(2) (C) and (D) of the Tax Reform Act of 1976 (90 Stat. 1595))

[T.D. 7474, 42 FR 17123, Mar. 31, 1977; T.D. 7480, 42 FR 19479, Apr. 14, 1977]

§7.48–3 Election to apply the amendments made by sections 804 (a) and (b) of the Tax Reform Act of 1976 to property described in section 50(a) of the Code.

(a) *General rule.* Under section 804(e)(2) of the Tax Reform Act of 1976 (90 Stat. 1596), taxpayers may elect to apply the amendments made by section 804 (a) and (b) of the Act to movie and television films that are property described in section 50(a) of the Code and that were placed in service in taxable years beginning before January 1, 1975.

(b) *Time for and manner of making election*—(1) *Time for making election.* The election under section 804(e)(2) the Act must be made not later than October 4, 1977.

(2) *Manner of making election.* The election under section 804(e)(2) shall be made by applying the same rules applicable under section 804(c)(2) as described in §7.48–2(b) (2), (3), and (4) except that §7.48–2(b)(2)(ii) shall be read to require a statement that the taxpayer is making an election under section 804(e)(2) of the Act, and §7.48–2(b)(2)(vi) shall not apply. An election properly made under section 804(e)(2) of the Act may not be revoked after October 4, 1977.

(Sec. 804(e)(2), Tax Reform Act of 1976 (90 Stat. 1596))

[T.D. 7509, 42 FR 47828, Sept. 22, 1977]

§7.57(d)–1 Election with respect to straight line recovery of intangibles.

(a) *Purpose.* This section prescribes rules for making the election permitted under section 57(d)(2), as added by the Tax Reform Act of 1976. Under this election taxpayers may use cost depletion to compute straight line recovery of intangibles.

(b) *Election.* The election under section 57(d) is subject to the following rules:

(1) The election is made within the time prescribed by law (including extensions thereof) for filing the return for the taxable year in which the intangible drilling costs are paid or incurred or, if later, by July 25, 1978.

(2) The election is made separately for each well. Thus, a taxpayer may

make the election for only some of his or her wells.

(3) The election is made by using, for the well or wells to which the election applies, cost depletion to compute straight line recovery of intangibles for purposes of determining the amount of the preference under section 57(a)(11).

(4) The election may be made whether or not the taxpayer uses cost depletion in computing taxable income.

(5) The election is made by a partnership rather than by each partner.

(c) *Computation of cost depletion.* For purposes of computing straight line recovery of intangibles through cost depletion, both depletable and depreciable intangible drilling and development costs for the taxable year are taken into account. They are treated as if capitalized, added to basis, and recovered under § 1.611–2(a). Costs paid or incurred in other taxable years are not taken into account.

(Secs. 57(d) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1551; 68A Stat. 917; 26 U.S.C. 57(d), 7805))

[T.D. 7541, 43 FR 17816, Apr. 26, 1978; 43 FR 18993, May 3, 1978]

§ 7.105–1 Questions and answers relating to exclusions of certain disability income payments.

The following questions and answers relate to the exclusion of certain disability income payments under section 105(d) of the Internal Revenue Code of 1954, as amended by sections 505 (a) and (c) of the Tax Reform Act of 1976 (90 Stat. 1566):

Q–1: *What effect on the sick pay exclusion does the new law have?*

A–1: The ''sick pay'' provisions of prior law (which allowed a limited exclusion from gross income of sick pay received before mandatory retirement age by active employees temporarily absent from work because of sickness or injury, as well as by disability retirees) have been replaced by provisions of the new law (which provide for a limited exclusion of disability payments but restrict its application to individuals retired on disability who meet certain requirements as to permanent and total disability, age, etc.) (Q–4). As a result of the more restrictive provisions of the new law, many taxpayers who qualified for the exclusion in previous taxable years will not be eligible to claim the disability payments exclusion beginning with the effective date of the new law.

Q–2: *What is the effective date of the new law relating to disability exclusion?*

A–2: The disability income exclusion and related annuity provisions of the Tax Reform Act of 1976 are effective for taxable years beginning on or after January 1, 1977. In addition, the Tax Reduction and Simplification Act of 1977 allows certain taxpayers to begin excluding pension or annuity costs in taxable years beginning in 1976. In the case of a retiree who uses the cash receipts and disbursements method of accounting, the new law applies to payments received on or after the effective date even if the payment is for a period before the effective date. Thus, a payment for December 1976 that is received in January 1977 by a calendar-year, cash-basis taxpayer is controlled by the new law.

Q–3: *What are disability payments?*

A–3: In general, disability payments are amounts constituting wages or payments in lieu of wages made under provisions of a plan providing for the payment of such amounts to an employee for a period during which the employee is absent from work on account of permanent and total disability. Amounts paid to such an employee after mandatory retirement age is attained are not wages or payments in lieu of wages for purposes of the disability income exclusion.

Q–4: *Who is eligible to exclude disability payments?*

A–4: A taxpayer who receives disability payments in lieu of wages under a plan providing for the payment of such amounts may qualify for the exclusion provided all of the following requirements are met:

(1) The taxpayer has not reached age 65 (see Q–9) before the end of the taxable year;

(2) The taxpayer has not reached mandatory retirement age (see Q–8) before the beginning of the taxable year;

(3) The taxpayer retired on disability (see Q–10) (or if retired prior to January 1, 1977 and did not retire on disability, would have been eligible to retire on disability at the time of such retirement);

(4) The taxpayer was permanently and totally disabled (see Q–11) when the taxpayer retired (or if the taxpayer retired before January 1, 1977, was permanently and totally disabled on January 1, 1976, or January 1, 1977); and

(5) The taxpayer has not made an irrevocable election not to claim the disability income exclusion (see Q–17 through Q–19).

Q–5: *What limitations are placed on the amounts excludable?*

A–5: The amount of disability income that is excludable:

(a) Cannot exceed the amount of the disability income payments received for any pay period;

(b) Cannot exceed a maximum weekly rate of $100 per taxpayer. Thus, the maximum disability income exclusion allowable on a joint return (see Q–7) in the usual case where one

spouse receives disability payments, generally, would be $5,200, and if both spouses received disability payments the maximum exclusion, generally, would be $10,400 ($5,200 for each spouse);

(c) Cannot exceed, in the case of a disability income payment for a period of less than a week, a prorated portion of the amount otherwise excludable for that week (see Q–6); and

(d) Cannot exceed, for the entire taxable year, the total amount otherwise excludable for such taxable year reduced, dollar for dollar, by the amount by which the taxpayer's adjusted gross income (determined without regard to the disability income exclusion) exceeds $15,000. Where a disability income exclusion is claimed by either or both spouses on a joint return, the taxpayer's adjusted gross income means the total adjusted gross income of both spouses combined (determined without regard to the disability income exclusion) (see also Q–7).

Q–6: *On what occasion is a taxpayer likely to receive part-week disability payments? How do you prorate such payments?*

A–6: Such part-week payments may be received when one of the following events occurs after the first day of the taxpayer's normal workweek: (a) the disability retirement commences: (b) the taxpayer reaches mandatory retirement age in a taxable year prior to the taxable year in which such taxpayer attains age 65; or (c) the taxpayer dies. To prorate a part-week disability income payment for purposes of the exclusion, the taxpayer must:

(1) Determine the ''daily exclusion,'' which is the lesser of—

(a) The taxpayer's daily rate of disability pay, or

(b) $100 divided by the number of days in the taxpayer's normal workweek.

(2) Multiply the daily exclusion by the number of days for which the part-week payment was made.

Thus, for a taxpayer whose normal workweek was Monday through Friday and whose retirement on permanent and total disability began on Wednesday, the first disability income payment would include a payment for a part-week consisting of three days. Assuming that the daily exclusion determined in (1), above, is $20, the taxpayer's exclusion for the first week would be $60 ($20×3).

Q–7: *What filing restrictions apply to a married taxpayer who claims a disability income exclusion?*

A–7: A taxpayer married at the close of the taxable year who lived with his or her spouse at any time during such taxable year must file a joint return in order to claim the disability income exclusion. However, a taxpayer married at the close of the taxable year who lived apart from his or her spouse for the entire taxable year may claim the exclusion on either a joint or separate return.

Q–8: *What is ''mandatory retirement age''?*

A–8: Generally, mandatory retirement age is the age at which the taxpayer would have been required to retire under the employer's retirement program, had the taxpayer not become disabled.

Q–9: *Does a taxpayer reach age 65 on the day before his or her 65th birthday for purposes of the disability income exclusion, as is the case for purposes of the exemption for age and the credit for the elderly?*

A–9: No. For purposes of the disability income exclusion, a taxpayer reaches age 65 on the day of his or her 65th birthday anniversary. Thus, a taxpayer whose 65th birthday occurs on January 1, 1978, is not considered to reach age 65 during 1977, for purposes of the disability income exclusion.

Q–10: *What does ''retired on disability'' mean?*

A–10: Generally, it means that an employee has ceased active employment in all respects because of a disability and has retired under a disability provision of a plan for employees. However, an employee who has actually ceased active employment in all respects because of a disability may be treated as ''retired on disability'' even though the employee has not yet gone through formal ''retirement'' procedures, as for example, where an employer carries the disabled employee in a non-retired status under the disability provisions of the plan solely for the purpose of continuing such employee's eligibility for certain employer-provided fringe benefits. In addition, such an employee may be treated as ''retired on disability'' even though the initial period immediately following his or her ceasing of employment on account of a disability must first be used against accumulated ''sick leave'' or ''annual leave'' prior to the employee being formally placed in disability retirement status.

Q–11: *What is permanent and total disability?*

A–11: It is the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that:

(a) Can be expected to result in death;

(b) Has lasted for a continuous period of not less than 12 months; or

(c) Can be expected to last for a continuous period of not less than 12 months. The substantial gainful activity referred to is not limited to the activity, or a comparable activity, in which the individual customarily engaged prior to such individual's retirement on disability.

See §7.105–2 for additional information relating to substantial gainful activity.

Q–12: *If a taxpayer retired on disability but it is not clear until the following taxable year that the disability as of the date of such retirement was permanent and total (so that the employee did not exclude any amount as disability income in the earlier taxable year), may the taxpayer*

file an amended return to claim the disability income exclusion for the taxable year in which such taxpayer retired on disability which was permanent and total?

A–12: Yes.

Q–13: *What proof must a taxpayer furnish to establish the existence of permanent and total disability?*

A–13: If retired on disability before January 1, 1977: A certificate from a qualified physician attesting that—

(a) The taxpayer was permanently and totally disabled on January 1, 1976 or January 1, 1977; or

(b) The records of the Veterans Administration show that the taxpayer was permanently and totally disabled as defined in 38 CFR 3.340 or 3.342 on January 1, 1976 or January 1, 1977.

If retired on disability during 1977 or thereafter: A certificate from a qualified physician attesting that—

(a) The taxpayer was permanently and totally disabled on the date he or she retired; or

(b) The records of the Veterans Administration show that the taxpayer was permanently and totally disabled as defined in 38 CFR 3.340 or 3.342 on the date he or she retired.

In either case, the taxpayer must attach the certificate or a copy of the certificate to his or her income tax return. The certificate shall give the physician's name and address. No certificate from any employer is required with regard to the determination of permanent and total disability.

Q–14: *For what period does a taxpayer eligible (see Q–4) for the disability income exclusion (without regard to the $15,000 income phaseout explained in Q–5) continue to be eligible for such exclusion?*

A–14: Unless the taxpayer earlier makes the irrevocable election not to claim the disability income exclusion described in Q–17 through Q–19, such taxpayer continues to be eligible until the earlier of:

(a) The beginning of the taxable year in which the taxpayer reaches age 65; and

(b) The day on which the taxpayer reaches mandatory retirement age.

Q–15: *May a taxpayer while eligible (see Q–4) for the disability income exclusion under the new law, exclude any applicable pension or annuity costs?*

A–15: No. This is true even though while eligible for the disability income exclusion, such taxpayer is unable to exclude any amount of the disability income payments because of the $15,000 income phaseout (see Q–5).

Q–16: *When will a taxpayer who is eligible (see Q–4) to exclude disability income payments (without regard to the $15,000 phaseout explained in Q–5) under the new law be able to exclude any applicable pension or annuity costs?*

A–16: In general, such a taxpayer will begin to exclude any of his or her pension or annuity costs under applicable rules of the Code beginning on the first day of the taxable year in which he or she attains age 65 or, if mandatory retirement age is attained in an earlier taxable year, beginning on the day the taxpayer attains mandatory retirement age.

Q–17: *May a taxpayer who is eligible (see Q–4) to exclude disability income payments (without regard to the $15,000 phaseout explained in Q–5) under the new law begin to exclude applicable pension or annuity costs in an earlier taxable year?*

A–17: Yes, but such a taxpayer must make the election described in Q–18 and Q–19 in which case the taxpayer would no longer be eligible for the disability income exclusion.

Q–18: *What is an election not to claim the disability income exclusion?*

A–18: It is an irrevocable election for the taxable year for which the election is made, and each taxable year thereafter. If such an election is made the taxpayer will begin to recover tax-free, out of the payments, his or her annuity costs as provided under the applicable provision of the Code.

Q–19: *How does a taxpayer who is eligible to exclude disability income payments (without regard to the $15,000 phaseout explained in Q–5) under the new law make this election?*

A–19: The election is made by means of a statement attached to the taxpayer's income tax return (or amended return) for the taxable year in which the taxpayer wishes to have the applicable annuity rule apply. The statement shall set forth the taxpayers qualifications to make the election (i.e., that the taxpayer is eligible (see Q–4) to exclude disability income payments (without regard to the $15,000 income phaseout explained in Q–5)) and that such taxpayer irrevocably elects not to claim the benefit of excluding disability income payments under section 105(d), as amended, for such taxable year and each taxable year thereafter. The election cannot be made for any taxable year beginning before January 1, 1976.

Q–20: *Did the changes made by the Tax Reduction and Simplification Act provide any relief to taxpayers eligible for the sick pay exclusion in taxable years beginning in 1976?*

A–20: Yes. As originally enacted, the more restrictive provisions of the disability income exclusion applied to taxable years beginning in 1976. The Tax Reduction and Simplification Act postponed the effective date

of these provisions for 1 year. Thus, taxpayers may claim the sick pay exclusion in taxable years beginning in 1976.

(Secs. 105(d) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1566; 68A Stat. 917; 26 U.S.C. 105(d); 7805))

[T.D. 7450, 41 FR 56630, Dec. 29, 1976, as amended at 42 FR 2954, Jan. 14, 1977; T.D. 7544, 43 FR 19655, May 8, 1978]

§ 7.105–2 Substantial gainful activity.

(a) *Purpose.* This section defines substantial gainful activity for purposes of section 105(d) and § 7.105–1, prescribes rules for determining whether a taxpayer has the ability to engage in substantial gainful activity, and provides examples of the application of the definition and rules in specific factual situations.

(b) *Definition.* Substantial gainful activity is the performance of significant duties over a reasonable period of time in work for remuneration or profit (or in work of a type generally performed for remuneration or profit).

(c) *General rules.* (1) Full-time work under competitive circumstances generally indicates ability to engage in substantial gainful activity.

(2) Work performed in self-care or the taxpayer's own household tasks, and nonremunerative work performed in connection with hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities is not substantial gainful activity. However, the nature of the work performed may be evidence of ability to engage in substantial gainful activity.

(3) The fact that a taxpayer is unemployed for any length of time is not, of itself, conclusive evidence of inability to engage in substantial gainful activity.

(4) Regular performance of duties by a taxpayer in a full-time, competitive work situation at a rate of pay at or above the minimum wage will conclusively establish the taxpayer's ability to engage in substantial gainful activity. For purposes of paragraphs (c)(4) and (c)(5) of this section, the minimum wage is the minimum wage prescribed by section 6(a)(1) of the Fair Labor Standards Act of 1938, as amended, 29 U.S.C. 206(a)(1).

(5) Regular performance of duties by a taxpayer in a part-time, competitive work situation at a rate of pay at or above the minimum wage will conclusively establish the taxpayer's ability to engage in substantial gainful activity, if the duties are performed at the employer's convenience.

(6) In situations other than those described in paragraphs (c)(4) and (c)(5) of this section, other factors, such as the nature of the duties performed, may establish a taxpayer's ability to engage in substantial gainful activity.

(d) *Examples.* The following examples illustrate the application of the definition in paragraph (b) of this section and the rules in paragraph (c) of this section in specific factual situations. In examples 1 through 5, the facts establish that the taxpayers are able to engage in substantial gainful activity and, therefore, are not entitled to claim the disability income exclusion of section 105(d). In examples 6 through 9, the facts do not, of themselves, establish the taxpayers' ability or inability to engage in substantial gainful activity. In these situations, all the facts and circumstances must be examined to determine whether the taxpayers are able to engage in substantial gainful activity.

Example (1). Before retirement on disability, taxpayer worked for a hotel as night desk clerk. After retirement, the taxpayer is hired by another hotel as night desk clerk at a rate of pay exceeding the minimum wage. Since the taxpayer regularly performs duties in a full-time competitive work situation at a rate of pay at or above the minimum wage, he or she is able to engage in substantial gainful activity.

Example (2). A taxpayer who retired on disability from employment as a sales clerk is employed as a full-time babysitter at a rate of pay equal to the minimum wage. Since the taxpayer regularly performs duties in a full-time, competitive work situation at a rate of pay at or above the minimum wage, he or she is able to engage in substantial gainful activity.

Example (3). A taxpayer retired on disability from employment as a teacher because of terminal cancer. The taxpayer's physician recommended continuing employment for therapeutic reasons and taxpayer accepted employment as a part-time teacher at a rate of pay in excess of the minimum wage. The part-time teaching work is done at the employer's convenience. Even though the taxpayer's illness is terminal, the employment

was recommended for therapeutic reasons, and the work is part-time, the fact that the work is done at the employer's convenience demonstrates that the taxpayer is able to engage in substantial gainful activity.

Example (4). A taxpayer who retired on disability, is employed full-time in a competitive work situation that is less demanding than his or her former position. The rate of pay exceeds the minimum wage but is about half of the taxpayer's rate of pay in the former position. It is immaterial that the new work activity is less demanding or less gainful than the work in which the taxpayer was engaged before his or her retirement on disability. Since the taxpayer regularly performs duties in a full-time, competitive work situation at a rate of pay at or above the minimum wage, he or she is able to engage in substantial gainful activity.

Example (5). A taxpayer who retired on disability from employment as a bookkeeper drives trucks for a charitable organization at the taxpayer's convenience. The taxpayer receives no compensation, but duties of this nature generally are performed for remuneration or profit. Some weeks the taxpayer works 10 hours, some weeks 40 hours, and over the year the taxpayer works an average of 20 hours per week. Even though the taxpayer receives no compensation, works part-time, and at his or her convenience, the nature of the duties performed and the average number of hours worked per week conclusively establish the taxpayer's ability to engage in substantial gainful activity.

Example (6). A taxpayer who retired on disability was instructed by a doctor that uninterrupted bedrest was vital to the treatment of his or her disability. However, because of financial need, the taxpayer secured new employment in a sedentary job. After attempting the new employment for approximately two months, the taxpayer was physically unable to continue the employment. The fact that the taxpayer attempted to work and did, in fact, work for two months, does not, of itself, conclusively establish the taxpayer's ability to engage in substantial gainful activity.

Example (7). A taxpayer who retired on disability accepted employment with a former employer on a trial basis. The purpose of the employment was to determine whether the taxpayer was employable. The trial period continued for an extended period of time and the taxpayer was paid at a rate equal to the minimum wage. However, because of the taxpayer's disability only light duties of a nonproductive make-work nature were assigned. Unless the activity is both substantial and gainful, the taxpayer is not engaged in substantial gainful activity. The activity was gainful because the taxpayer was paid at a rate at or above the minimum wage. However, the activity was not substantial because the duties were of a nonproductive, make-work nature. Accordingly, these facts do not, of themselves, establish the taxpayer's ability to engage in substantial gainful activity.

Example (8). A taxpayer who retired on disability from employment as a bookkeeper lives with a relative who manages several motel units. The taxpayer assisted the relative for one or two hours a day by performing duties such as washing dishes, answering phones, registering guests, and bookkeeping. The taxpayer can select the times during the day when he or she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at the taxpayer's convenience, is not activity of a ''substantial and gainful'' nature even if the individual is paid for the work. The performance of these duties does not, of itself, show that the taxpayer is able to engage in substantial gainful activity.

Example (9). A taxpayer who retired on disability because of a physical or mental impairment accepts sheltered employment in a protected environment under an institutional program. Sheltered employment is offered in sheltered workshops, hospitals and similar institutions, homebound programs, and Veterans Administration domiciliaries. Typically, earnings are lower in sheltered employment than in commercial employment. Consequently, impaired workers normally do not seek sheltered employment if other employment is available. The acceptance of sheltered employment by an impaired taxpayer does not necessarily establish his or her ability to engage in substantial gainful activity.

(Secs. 105(d) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1566; 68A Stat. 917; 26 U.S.C. 105(d); 7805))

[T.D. 7544, 43 FR 19656, May 8, 1978]

§ 7.367(b)–1 Other transfers.

(a) *Scope.* This section and §§ 7.367(b)–2 through 7.367(b)–12 apply to exchanges to which section 367(b), as amended by section 1042(a) of the Tax Reform Act of 1976, applies. This section sets forth certain general rules regarding the extent to which a foreign corporation shall be considered to be a corporation in connection with an exchange to which section 367(b) applies. An exchange to which section 367(b) applies is an exchange described in section 367(b) and in section 332, 351, 354, 355, 356, or 361 with respect to which the status of a foreign corporation as a corporation is relevant for determining the extent to which gain shall be recognized and in connection with which there is no transfer described in section

367(a). An election by a domestic corporation under section 1504(d) to treat a corporation organized under the laws of a contiguous foreign country as a domestic corporation shall be considered to be a transfer of property made pursuant to an exchange to which section 367(b) applies.

(b) *General rule.* If section 367(b) applies to an exchange, a foreign corporation shall be considered to be a corporation in respect of that exchange except to the extent otherwise provided in this section and in §§ 7.367(b)–4 through 7.367(b)–12. Unless otherwise provided, if a taxpayer fails to comply with §§ 7.367(b)–1 through 7.367(b)–12, the Commissioner shall make a determination whether a foreign corporation will be considered to be a corporation based on all the facts and circumstances surrounding failure to comply. In making this determination the Commissioner may conclude that:

(1) A foreign corporation will be considered to be a corporation despite the failure to comply;

(2) A foreign corporation will be considered to be a corporation provided that the conditions imposed under §§ 7.367(b)–4 through 7.367(b)–12 are fulfilled; or

(3) A foreign corporation will not be considered to be a corporation only for purposes of determining the extent to which gain shall be recognized on such exchange but that any gain recognized by reason of the Commissioner's determination to disregard the corporate status of a foreign corporation will be taken into account for purposes of applying the provisions of section 334, 358 or 362.

See, §§ 7.367(b)–5(b), 7.367(b)–6(c), 7.367(b)–7(c)(2), and 7.367(b)–10(j) for specific provisions which override the provisions of paragraph (b)(3) of this section.

(c) *Notice required*—(1) *In general.* If any person referred to in section 6012 (relating to the requirement to make returns of income) realized gain or other income (whether or not recognized) on account of any exchange to which section 367(b) applies, such person must file a notice of such exchange on or before the last date for filing a Federal income tax return (taking into account any extensions of time therefor) for the person's taxable year in which gain or other income is realized. This notice must be filed with the district director with whom the person would be required to file a Federal income tax return for the taxable year in which the exchange occurs.

(2) *Information required.* The notice shall contain:

(i) A statement that the exchange is one to which section 367(b) applies;

(ii) A complete description of the exchange;

(iii) A description of any stock or securities received in the exchange;

(iv) A statement which describes any amount required, under §§ 7.367(b)–4 through 7.367(b)–12 to be included in gross income or added to the earnings and profits or deficit of an exchanging foreign corporation for the person's taxable year in which the exchange occurs;

(v) A statement which describes any amount of earnings and profits attributed by reason of the exchange under §§ 7.367(b)–4 through 7.367(b)–12, to stock owned by any United States person;

(vi) Any information which is or would be required to be furnished with a Federal income tax return pursuant to regulations under sections 332, 351, 354, 355, 356, 361, or 368 (whether or not a Federal income tax return is required to be filed) if such information has not otherwise been provided;

(vii) Any information required to be furnished under section 6038 or 6046 if such information has not otherwise been provided; and

(viii) If applicable, a statement that the taxpayer is making the election permitted under paragraph (d) of § 7.367(b)–3 relating to earnings and profits of a less developed country corporation.

(ix) If applicable, a statement that all relevant shareholders are making the election provided in paragraph (c)(1)(iii) of § 7.367(b)–7, in paragraph (f) of § 7.367(b)–9, in paragraph (i)(3)(ii)(C) of § 7.367(b)–10, or in paragraph (f) of § 7.367(b)–10 in order to obtain the increase in basis of stock provided in paragraph (c)(1)(iii) of § 7.367(b)–7, paragraph (i)(3)(ii)(C) of § 7.367(b)–10, paragraph (e)(1) of § 7.367(b)–9, or paragraph (e) of § 7.367(b)–10.

(3) *Failure to provide notice.* If a person required to give notice under pagraph (c)(1) of this section fails to provide, in a timely manner, information sufficent to apprise the Commissioner of the occurrence and nature of an exchange to which section 367(b) applies, the taxpayer will be considered to have failed to comply with the provisions of §§ 7.367(b)–1 through 7.367(b)–12 only if the taxpayer fails to establish reasonable cause for the failure.

(d) *Records to be kept*—(1) *Adjustments to earnings and profits.* Any corporation whose earnings and profits are required to be adjusted under §§ 7.367(b)–4 through 7.367(b)–12 must keep records adequate to establish the adjustment.

(2) *Amounts attributed to stock.* If, under §§ 7.367(b)–4 through 7.367(b)–12, an amount is attributable to stock in a foreign corporation which is owned by a United States person, that person must keep records to establish the amount so attributed. If the person fails to maintain such records, and an inclusion in gross income of such amount is required by reason of section 1248 or §§ 7.367(b)–4 through 7.367(b)–12, the district director shall make a reasonable determination of the amount attributed.

(e) *Close of taxable year in certain section 368(a)(1)(F) reorganizations.* If a foreign corporation is the transferor corporation in a reorganization described in section 368(a)(1)(F) after March 30, 1987, in which the acquiring corporation is a domestic corporation, then the taxable year of the transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the transfer. If a foreign corporation, with effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits (as defined in the regulations under section 884), is the transferor corporation in a reorganization described in section 368(a)(1)(F) in a taxable year beginning after February 15, 1990 (or in a taxable year beginning after December 31, 1986, and on or before February 15, 1990 to which the transferor corporation chooses to apply this rule), in which the acquiring corporation is a foreign corporation, then the taxable year of the transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the transfer. With regard to the consequences of the closing of the taxable year, see section 381 and the regulations thereunder.

(f) *Exchanges under sections 354(a) and 361(a) in certain section 368(a)(1)(F) reorganizations.* In every reorganization under section 368(a)(1)(F), where the transferor corporation is a foreign corporation, there is considered to exist—

(1) A transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's liabilities;

(2) A distribution of the stock (or stock and securities) of the acquiring corporation by the transferor corporation to the shareholders (or shareholders and security holders) of the transferor corporation; and

(3) An exchange by the transferor corporation's shareholders (or shareholders and security holders) of the stock (or stock and securities) of the transferor corporation for stock (or stock and securities) of the acquiring corporation under section 354(a).

For this purpose, it shall be immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuance of the transferor corporation.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634; 26 U.S.C. 367))

[T.D. 7530, 42 FR 65157, Dec. 30, 1977, as amended by T.D. 8087, 51 FR 17960, May 16, 1986; T.D. 8280, 55 FR 1417, Jan. 16, 1990]

§ 7.367(b)–2 Definitions.

(a) *Controlled foreign corporation.* The term ''controlled foreign corporation'' means a controlled foreign corporations as defined in section 957 and the regulations thereunder.

(b) *United States shareholder.* The term ''United States shareholder'' means any United States person who

satisfies the ownership requirements of section 1248(a)(2) or of section 1248(c)(2) with respect to a foreign corporation.

(c) *Section 1246 amount.* In the case of an exchange of stock in a foreign investment company (as defined in section 1246(b)) to which section 367(b) applies, the term ''section 1246 amount'', means the earning and profits, if any, of the foreign investment company, which would have been attributable under section 1246 and the regulations thereunder to the stock exchanged if the stock had been sold in a transaction to which section 1246 applied.

(d) *Section 1248 amount.* See § 1.367 (b)–2 (d) of this chapter.

(e) *Section 1248(c)(2) amount.* In the case of an exchange of stock in a lower-tier foreign corporation to which section 367(b) applies and which is made by another foreign corporation, the term ''section 1248(c)(2) amount'' means the earnings and profits or deficit in earnings and profits which would have been attributable under section 1248(c)(2) and the regulations thereunder to the stock of the foreign corporation exchanged (including stock in other lower-tier corporations owned by reason of ownership of the stock exchanged). The determination shall be made as if stock in any first-tier corporation by reason of the ownership of which the United States shareholder owns the stock exchanged had been sold in a transaction to which section 1248(a) applied.

(f) *All earnings and profits amount.* See § 1.367e(b)–2(f) of this chapter.

(g) *Additional earnings and profits amount.* The term ''additional earnings and profits amount'' means the earnings and profits or deficit in earnings and profits for taxable years beginning before Janurary 1, 1963, which are attributable under the principles of section 1248 and the regulations thereunder to the stock of the foreign corporation exchanged. The determination shall be made by applying section 1248 as modified by §§ 7.367(b)–2 through 7.367(b)–12 as if there were no distinction in those sections between earnings and profits accumulated before of after December 31, 1962.

(h) *All earnings and profits amount or additional earnings and profits amount.* In computing an ''all earnings and profits amount'' or ''additional earnings and profits amount'' under the principles of section 1248, if the stock exchanged is:

(1) Stock in a first-tier corporation, then section 1248(c)(2) (inclusion of earnings and profits of subsidiaries) does not apply.

(2) Stock in a lower-tier corporation, then section 1248(c)(2) shall be applied to determine the earnings and profits of that lower-tier corporation which are attributable to the stock exchanged but that section shall not be applied with respect to any other lower-tier corporations.

(i) *Inclusion of earnings and profits described in section 1248(d).* For purposes of computing any of the amounts defined in paragraphs (d) through (g) of this section, the exclusions from earnings and profits provided for under section 1248(d) shall not apply. See, however, paragraph (c) of § 7.367(b)–3 (relating to amounts retaining character as exclusions under section 1248(d)).

(j) *Corporations organized under laws of Puerto Rico or United States possessions corporations.* For purposes of computing the amounts defined in paragraphs (f) and (g) of this section, if, for a taxable year, a corporation organized in or under the laws of the Commonwealth of Puerto Rico or a possessions of the United States meets the requirements of section 957(c) (or would have met such requirement if the Revenue Act of 1962 had been in effect) then:

(1) Earnings and profits accumulated by the corporations during such a taxable year which begins before January 1, 1978, are not required to be taken into account, and

(2) Earnings and profits accumulated by the corporation during such a taxable year which begins after December 31, 1977, are required to be taken into account only to the extent such earnings would not qualify for the credit of section 936(a) had the corporation been a domestic corporation which met the requirements of section 936(a)(1) and which had elected the credit under that section.

A corporation which, during its first taxable year beginning after December 31, 1962, meets the requirements of section 957(c) will be considered to have met such requirements during taxable

years beginning prior to January 1, 1963.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65158, Dec. 30, 1977, as amended by T.D. 8243, 54 FR 9201, Mar. 6, 1989, T.D. 8397, 57 FR 6556, Feb. 26, 1992]

§ 7.367(b)–3 Special rules.

(a) *Character of section 1246 amount.* If, under § 7.367(b)–6, an amount attributable to stock in a foreign investment company (as defined in section 1246(b)) is required to be taken into gross income of its shareholders, such earnings and profits will be included in income as—

(1) Gain from the sale of an asset which is not a capital asset to the extent attributable to earnings and profits accumulated in taxable years beginning after December 31, 1962; and

(2) A dividend deemed paid in money to the extent attrubutable to earnings and profits accumulated in taxable years beginning before January 1, 1963, and required to be included as part of the ''all earnings and profits amount''.

(b) *Character of amounts computed under the principles of section 1248.* If, under § 7.367(b)–5 or §§ 7.367(b)–7 through 7.367(b)–12, any amount is required to be included in the gross income of a United States person, that amount shall be considered to have been distributed as a dividend paid in money immediately prior to the exchange and taxable under section 301 as a dividend formally declared in the same amount.

(c) *Amounts retaining character as exclusions under section 1248(d).* (1) Amounts described in paragraphs (d) through (g) of § 7.367(b)–2 which must be included in gross income of a United States person shall be reduced—

(i) In all cases, by earnings and profits retaining their character as exclusions under section 1248(d) (1), (2), (4), and (5), and

(ii) If the inclusion in gross income is required by a provision other than paragraph (b) of § 7.367(b)–5, paragraph (c)(2) of § 7.367(b)–7, or paragraph (j) of § 7.367(b)–10, by earnings and profits retaining their character as exclusions under section 1248(d)(3). See, however, paragraph (d) of this section.

(2) Amounts described in paragraph (e) or (g) of § 7.367(b)–2 which must be added to the earnings and profits or deficit of an exchanging foreign corporation shall not be reduced by earnings and profits retaining their character as exclusions under section 1248(d).

(d) *Less developed country corporation election.* This paragraph applies to all earnings and profits of a character described in section 1248(d)(3). Any such earnings and profits which are required to be included in gross income of a domestic corporate shareholder as part of an all earnings and profits amount may, at the election of such taxpayer, be taxed as gain from the sale of a capital asset. Such election shall be made in the notice required under paragraph (c) of § 7.367(b)–1. A corporation which during its first taxable year beginning after December 31, 1962, meets the requirements of section 902(d), as in effect before the enactment of the Tax Reduction Act of 1975, will be considered to have met such requirements during taxable years beginning prior to January 1, 1963.

(e) *Character of certain earnings and profits.* Earnings and profits or a deficit in earnings and profits to which a corporation succeeds under section 381(a)(1) or amounts which are attributed to stock under §§ 7.367(b)–9, 7.367(b)–10, and 7.367(b)–12 shall retain their character. Earnings and profits or deficits shall be considered as if accumulated or incurred by the corporation which succeeds to such earnings and profits or deficits.

This paragraph applies for all purposes, including but not limited to sections 901 to 908, 959, 960, 1248, and §§ 7.367(b)–1 through 7.367(b)–12.

(f) *Foreign tax credit.* If an amount of earnings and profits of a foreign corporation which is considered to have been distributed as a dividend is included in gross income of a United States person, the foreign tax credit provisions (sections 78, and 901 through 908) shall apply as if such earnings and profits were actually distributed by a foreign corporation as a dividend.

(g) *Treatment of section 1248 amounts and section 1248(c)(2) amounts where attribution is not made.* (1) The portion of the section 1248 amount included in gross income of a United States person

which is attributable to each particular foreign corporation shall be determined as follows. First, the total gross earnings and profits (determined without regared to any deficit) attributable to each particular corporation shall be determined as if it were the only corporation included in the section 1248 amount. In situations to which §7.367(b)–10 applies, the determination shall be made without regard to the allocation under paragraph (d) of that section. Next, that amount shall be multiplied by the amount included in gross income. Finally, the product shall be divided by the section 1248 amount. The result will be the amount of earnings and profits from that particular corporation which are included in gross income.

(2) The section 1248 amount included in gross income by a United States person which is attributable to the earnings and profits of a foreign corporation shall be considered as if distributed directly to the United States person by the foreign corporation. A section 1248(c)(2) amount which is added to the earnings and profits or deficit of an exchanging foreign corporation shall be considered as if accumulated or incurred directly by the exchanging foreign corporation.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65158, Dec. 30, 1977]

§7.367(b)–4 Certain exchanges described in more than one Code provision.

(a) *Scope.* This section provides special rules for purposes of applying section 367 to certain exchanges which are described in more than one section of subchapter C of chapter 1 of subtitle A of the Code.

(b) *Treatment of certain exchanges described in both section 354 and in either section 351 or 361*—(1) *In general.* If an exchange of stock in a foreign corporation (whether or not a controlled foreign corporation) by a United States person (whether or not a United States shareholder within the meaning of §7.367(b)–2(b)) pursuant to a reorganization described in section 368(a)(1)(B) involving a foreign corporation transferee is described in section 351 or section 361 as well as in section 354, such exchange is not an exchange described in section 367(a)(1) and—

(i) If the exchanging shareholder is a United States shareholder (within the meaning of §7.367(b)–2(b)) of the corporation whose stock is exchanged—

(A) The exchange shall be subject to the rules of §7.367(b)–7, and

(B) The excess of the gain realized (i.e., the fair market value of the stock received over the adjusted basis of the stock exchanged) over the section 1248 amount taken into account under §7.367(b)–7 shall be included in the gross income of the exchanging shareholder as gain recognized from the sale or exchange of the stock exchanged; or

(ii) If the exchanging shareholder is not a United States shareholder (within the meaning of §7.367(b)–2(b)) of the corporation whose stock is exchanged, the entire amount of gain realized (i.e., the fair market value of the stock received over the adjusted basis of the stock exchanged) shall be included in the gross income of the exchanging shareholder as gain recognized from the sale or exchange of the stock exchanged.

(2) *Exceptions.* This subparagraph (2) applies only to the gain treated as gain recognized on the sale or exchange of the stock exchanged and does not apply to any amount subject to the rules of §7.367(b)–7, as provided in paragraph (b)(1)(i)(A) of this section.

(i) *Specified treatment.* If an exchange of stock in a foreign corporation by a U.S. person is an exchange to which the rules under section 367(a) apply, then the gain required to be included in gross income under paragraph (b)(1)(i)(B) or paragraph (b)(1)(ii) of this section shall not be required to be immediately recognized under this paragraph (b), and instead the transaction shall be treated in accordance with the regulations under section 367(a). See §1.367(a)–3T.

(ii) *Controlled foreign corporations.* If—

(A) The transferee corporation is a controlled foreign corporation after the transfer, and

(B) The exchanging shareholder is a United States shareholder (within the meaning of §7.367(b)–2(b)) of the corporation whose stock is exchanged both before and after the transfer and of the transferee corporation after the

transfer, then paragraph (b)(1)(i)(B) of this section shall not apply.

(3) *Effective date.* The rules of this paragraph (b) apply to exchanges that begin after January 26, 1983. For the rules applicable to exchanges that began before that date, see 26 CFR 7.367(b)–4(b) as it appeared in the *Code of Federal Regulations* revised as of April 1, 1982. However, the rules contained in paragraph (b) (1) and (2) of this section for the treatment of certain exchanges described in that paragraph may, at the option of the taxpayer, apply also to any exchange beginning after December 31, 1977, and during a taxable year with respect to which action by the Internal Revenue Service is not barred by any statute of limitations.

(c) *Precedence of section 1036 over section 354.* If an exchange of stock in a foreign corporation pursuant to a reorganization is described both in sections 354 and 1036, the exchange will be considered to be described in section 1036, unless the stock surrendered is stock to which an amount h as been attributed under §§ 7.367(b)–5 through 7.367(b)–12. In that event, the provisions of these regulations shall apply to the attributed amounts as if section 1036 did not apply to the subsequent exchange.

(d) *Special definition of reorganization described in section 368(a)(1)(F).* For purposes of section 367(b) and §§ 7.367(b)–1 through 7.367(b)–12, a reorganization will be considered to be described in section 368(a)(1)(F) only if it involves a mere change in identity, form, or place of organization, however effected, of a single corporate entity.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65159, Dec. 30, 1977, as amended by T.D. 7863, 47 FR 57490, Dec. 27, 1982; T.D. 8087, 51 FR 17961, May 16, 1986]

§ 7.367(b)–5 Complete liquidation of foreign subsidiary.

(a) *Scope.* This section applies to an exchange described in section 332 which involves receipt of a distribution in complete liquidation of a foreign corporation.

(b) *Receipt of distribution by a domestic corporation.* If a domestic corporation which receives a distribution in complete liquidation of a foreign corporation includes in its gross income the all earnings and profits amount attributable to its stock in the distributor foreign corporation, the foreign corporation will be considered to be a corporation for purposes of applying Subchapter C of Chapter I of Subtitle A of the Code. The domestic corporation must include the all earnings and profits amount in gross income for the taxable year in which occurs the date of distribution (within the meaning of section 381(b)(2) and the regulations thereunder). If the domestic corporation does not include this amount in gross income, for the purpose of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the provisions of the Code other than section 332 shall apply as if the foreign corporation were considered a corporation. For example, sections 334(b)(1) and 381(a)(1) shall apply where applicable.

(c) *Receipt of distribution by a foreign corporation.* If a foreign corporation receives a distribution in complete liquidation of another foreign corporation, a foreign corporation will be treated as a corporation for purposes of section 332 and other applicable sections such as section 381.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65159, Dec. 30, 1977]

§ 7.367(b)–6 Exchange of stock in a foreign investment company.

(a) *Scope.* This section applies to an exchange of stock in a foreign investment company (as defined in section 1246(b)) if:

(1) The exchange is described in section 354 or 356 pursuant to any reorganization described in subparagraph (B), (C), (D), or (F) of section 368(a)(1) and in section 368(a)(2)(F) (if applicable), and

(2) Stock in a domestic corporation is received pursuant to the exchange. In the case of an exchange to which stock in a foreign corporation is received see section 1246(c).

(b) *General rule.* Except as provided in paragraph (c) of this section, a taxpayer who makes an exchange to which this section applies shall include in gross income for its taxable year in

which the exchange occurs the section 1246 amount attributable to the stock in the foreign investment company which was exchanged to the extent of the excess of the fair market value of such stock over its adjusted bases.

(c) *Exchange pursuant to certain asset acquisitions.* (1) If the exchange to which this section applies is made pursuant to a reorganization described in section 368(a)(1) (C), (D), or (F) involving the acquisition of assets of a foreign investment company (the ''acquired corporation'') by a domestic corporation, and the exchanging taxpayer is a domestic corporation, such taxpayer shall include in gross income for its taxable year in which the exhange occurs the all earnings and profits amount with respect to that stock computed in accordance with the principles of section 1246.

(2) If the domestic corporation does not include the amount referred to in paragraph (c)(1) of this section in gross income, for the purpose of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the provisions of the Code other than section 354 or 356 shall apply as if the foreign corporation were considered a corporation. For example, sections 358, 362, and 381 (if applicable) shall apply as if no gain had been recognized.

(d) *Adjustment to basis.* Any amount included in gross income under paragraph (b) or (c)(1) of this section which is characterized as gain from the sale of an asset which is not a capital asset shall be treated as gain recognized for purposes of applying sections 358 and 362.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65159, Dec. 30, 1977]

§7.367(b)–7 Exchange of stock described in section 354.

(a) *Scope.* This section applies to an exchange of stock in a foreign corporation (other than a foreign investment company as defined in section 1246(b)) if:

(1) The exchange is described in section 354 or 356 and is made pursuant to a reorganization described in section 368(a)(1) (B) through (F); and

(2) The exchanging person is either a United States shareholder or a foreign corporation having a United States shareholder who is also a United States shareholder of the corporation whose stock is exchanged.

(b) *Receipt of stock in a controlled foreign corporation.* If an exchanging shareholder receives stock of a controlled foreign corporation in an exchange to which this section applies (other than in an exchange pursuant to a reorganization described in section 368(a)(1) (E) or (F)), §7.367(b)–9 applies if, with respect to such corporation, immediately after the exchange—

(1) The exchanging shareholder is a United States shareholder of that controlled foreign corporation, or

(2) All United States shareholders of the exchanging foreign corporate shareholder are United States shareholders of that controlled foreign corporation.

(c) *Receipt of other stock*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, if an exchanging shareholder receives stock of a domestic corporation, or stock of a foreign corporation which is not a controlled foreign corporation, or stock of a controlled foreign corporation as to which the exchanging United States shareholder or any United States shareholder of the exchanging foreign corporation is not a United States shareholder, then—

(i) An exchanging United States shareholder shall include in gross income the section 1248 amount attributable to the stock exchanged, to the extent that the fair market value of the stock exchanged exceeds its adjusted basis, or

(ii) See §1.367 (b)–7 (c)(1)(ii) of this chapter.

(iii) See §1.367 (b)–7 (c)(1)(iii) of this chapter.

(iv) In situations to which paragraph (c)(1)(ii) of this section applies, the basis of the stock received by the exchanging shareholder shall be increased by the earnings and profits added to the earnings and profits of the exchanging foreign corporation under

paragraph (c)(1)(ii) of this section. Correspondingly, the basis of such exchanging shareholder shall be decreased by any deficits added to deficits of the exchanging foreign corporation under paragraph (c)(1)(ii) of this section. Any increase in basis attributable to earnings and profits included in the section 1248(c)(2) amount referred to in paragraph (c)(1)(ii) of this section shall be made only if all United States shareholders of the exchanging corporation consent to treat amounts added to the earnings and profits of the exchanging foreign corporation as a dividend. Such consent shall be given in the notice required by paragraph (c) of § 7.367(b)–1. See paragraph (f)(1) of § 7.367(b)–9 for the effect of such election. The adjustment to basis in respect of earnings and profits or deficit accumulated or incurred in taxable years beginning before January 1, 1963, shall be taken into account only for purposes of computing an all earnings and profits amount and additional earnings and profits amount, where such amounts must be computed after an exchange of stock the basis of which has been adjusted under this paragraph (c)(1)(iii).

(2) *Exchange of stock by certain domestic corporations.* (i) A United States person shall include in gross income the all earnings and profits amount if:

(A) Pursuant to a reorganization described in section 368(a)(1) (C), (D), or (F), assets of a foreign corporation are acquired by a domestic corporation;

(B) The exchanging United States person is a domestic corporation; and

(C) Such United States person receives stock of a domestic corporation in exchange for its stock in the acquired corporation.

(ii) If the domestic corporation does not include this amount in gross income, for the purpose of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the applicable provisions of the Code other than section 354 or 356 shall apply as if the foreign corporation were considered a corporation. For example, sections 358, 362, and 381, if applicable, shall apply as if no gain had been recognized.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65160, Dec. 30, 1977, as amended by T.D. 8243, 54 FR 9202, Mar. 6, 1989, T.D. 8397, 57 FR 6556, Feb. 26, 1992]

§ 7.367(b)–8 Transfer of assets by a foreign corporation in an exchange described in section 351.

(a) *Scope.* This section applies to a transfer of property pursuant to an exchange described in section 351, regardless of whether the transfer is also described in section 361, if:

(1) The transferor of property is a foreign corporation; and

(2) In the case of a transfer also described in section 361, the transferor remains in existence immediately after the transaction.

(b) *Section 381 inapplicable.* If this section applies to a transfer described in section 361, section 381(a)(2) shall not apply with respect to items described in section 381(c)(2).

(c) *Transfer of stock in controlled foreign corporation.* If the transferor corporation transfers stock in a foreign corporation of which there is a United States shareholder immediately before the exchange, and the transferor receives stock—

(1) Of a controlled foreign corporation as to which all United States shareholders of the transferor corporation remain United States shareholders, § 7.367(b)–9 shall apply.

(2) See § 1.367(b)–8(c)(2) of this chapter.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65160, Dec. 30, 1977, as amended by T.D. 8397, 57 FR 6556, Feb. 26, 1992]

§ 7.367(b)–9 Attribution of earnings and profits on an exchange described in section 351, 354, or 356.

(a) *Scope.* This section applies to a transaction involving an exchange of stock in a foreign corporation to which paragraph (b) of § 7.367(b)–7 or paragraph (c)(1) of § 7.367(b)–8 applies.

(b) *General rule.* Upon an exchange of stock to which this section applies:

(1) The section 1248 amount, the section 1248(c)(2) amount, the all earnings

and profits amount and the additional earnings and profits amount shall be computed with respect to each United States shareholder and to each foreign corporation as to which there is a United States shareholder who exchanges stock in the transaction. The amounts so computed shall be attributed to the stock received by each exchanging shareholder in the exchange in accordance with the principles of §§ 1.1248–2 and 1.1248–3. For the effect of attribution, see § 7.367(b)–12.

(2) Earnings and profits or deficit of the corporation whose stock is received in the exchange shall be increased as provided in paragraph (c) of this section.

(3) Earnings and profits or deficit of the corporation whose stock is exchanged and of any lower-tier corporations whose earnings and profits would be taken into account under section 1248(c)(2) shall be reduced as provided in paragraph (d) of this section.

(4) See § 1.367(b)–9(b)(4) of this chapter.

(c) *Earnings and profits or deficits of the corporation whose stock is received.* (1) Earnings and profits or deficit of the corporation whose stock is received in the exchange shall be increased by the earnings and profits or deficit to which it would succeed if:

(i) That corporation were the acquiring corporation, within the meaning of paragraph (b)(2) of § 1.381(a)–1, in a transaction to which section 381 applies (whether or not section 381 applies or that corporation would be considered the acquiring corporation); and

(ii) The corporation whose stock is exchanged, and each lower-tier corporation whose earnings and profits would be taken into account in calculating a section 1248 or section 1248(c)(2) amount, were a transferor corporation for purposes of section 381(a)(2).

A corporation which actually is the acquiring corporation in a transaction to which section 381(a)(2) applies shall not succeed to an item of the transferor described in section 381(c)(2) by reason of section 381(a)(2). However, that corporation shall succeed to all other items described in section 381(c).

(2) To the extent that the corporation whose stock is received does not acquire, either directly or through other entities, all the stock of the corporation whose stock is exchanged or of any lower-tier corporation whose earnings and profits would be taken into account in calculating a section 1248(c)(2) amount, paragraph (c)(1) of this section shall apply only to the proportion of earnings and profits or deficits attributable to the stock acquired. Such proportion shall be determined as if the earnings and profits or deficits were section 1248 or section 1248(c)(2) amounts. The earnings and profits or deficit to which the corporation whose stock is received does not succeed by reason of this paragraph shall be considered entirely attributable to the stock not acquired by the corporation whode stock is received.

(d) *Earnings and profits of corporation whose stock is exchanged and of lower-tier corporation.* The earnings and profits or deficit of the corporation whose stock is exchanged and of any lower-tier corporation whose earnings and profits or deficit would be taken into account under section 1248 shall be reduced to the extent that the adjustment required under paragraph (c) of this section is attributable to earnings and profits or deficit of that corporation.

(e) *Adjustment to basis.* (1) This paragraph (e)(1) applies to increases and decreases to basis of stock in corporations which as to the corporation whose stock is exchanged are lower-tier corporations. To the extent that earnings and profits of corporations (other than the corporations whose stock is exchanged) are reduced under paragraph (d) of this section, the basis in stock of each corporation whose earnings and profits are so reduced shall, in the hands of its immediate shareholder, be increased. The increase shall equal the total reduction in earnings and profits in respect of all corporations which as to such immediate shareholder are lower-tier corporations. Correspondingly, the basis to such immediate shareholder of stock in a corporation (other than the corporation whose stock is exhanged) whose deficit is reduced shall be decreased by the total reduction in deficits in respect of the corporations which as to

that shareholder are lower-tier corporations.

(2) This paragraph (e)(2) applies to increases and decreases to basis of stock in corporations which are not lower-tier corporations as to the corporation whose stock is exchanged but are lower-tier corporations of the corporation whose stock is received. In the case of a reorganization described in section 368(a)(1)(B) or of a reorganization in which the acquiring corporation, within the meaning of § 1.381(a)–1(b)(2), is a lower-tier corporation as to the corporation whose stock is received, the basis of stock shall be adjusted as provided in this paragraph (e)(2). To the extent that earnings and profits of the corporation whose stock is exchanged and of its lower-tier corporations are reduced under paragraph (d) of this section, the basis to the immediate corporate shareholder:

(i) Of stock in the corporation whose stock is exchanged, or

(ii) Of stock in a corporation (other than the corporation whose stock is received) which is the acquiring corporation of the corporation whose stock is exchanged,

shall be increased by the total reduction in earnings and profits under paragraph (d) of this section, except to the extent that the basis of such stock is determined by reference to the basis of the assets of the corporation whose stock is exchanged. The basis in such stock to each immediate corporate shareholder shall be similarly increased, and such increase shall in turn be made at each successive tier. The basis of the stock of the corporation whose stock is received, however, shall not be increased. Correspondingly, the basis of such stock to each immediate corporate shareholder, and at each successive higher tier, shall be decreased by the total reduction in deficits under paragraph (d) of this section, except to the extent that the basis of such stock is determined by reference to the basis of the assets of the corporation whose stock is exchanged.

(3) Any adjustment to basis in respect of earnings and profits or deficit accumulated or incurred in taxable years beginning before January 1, 1963, shall be taken into account only for purposes of computing all the earnings and profits and additional earnings and profits amounts.

(f) *Election as condition of increase in basis with respect to post-1962 earnings and profits.* (1) An increase in basis under paragraph (e)(1) of this section attributable to earnings and profits for taxable years beginning after December 31, 1962, shall be made only if all United States shareholders of the corporation whose corporation whose stock is exchanged make a consent dividend election in the notice required by paragraph (c) of § 7.367(b)–1. If such consent is made, the portion of such earnings and profits attributable to each particular corporation shall be treated as if, immediately prior to the reorganization, it had been distributed as a dividend through any intervening corporations to the corporation whose stock is exchanged.

(2) An increase in basis under paragraph (e)(2) of this section attributable to earnings and profits for taxable years beginning after December 31, 1962, shall be made only if:

(i) An election has been made under paragraph (f)(1) of this section, and

(ii) All United States shareholders of the corporation whose stock is received make a consent dividend election as provided in section 565 for the taxable year in which the reorganization occurs.

If such consent is made, such earnings and profits attributable to the corporation whose stock is exchanged and of its lower-tier corporations whose earnings and profits were reduced under paragraph (d) of this section shall be treated as if immediately after the reorganization, it had been distributed as a dividend through any intervening corporations to the corporation whose stock is received.

(3) See sections 553, 951 and 959 as to the possible effect of an election under this section.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65160, Dec. 30, 1977, as amended by T.D. 8243, 53 FR 9202, Mar. 6, 1989, T.D. 8397, 57 FR 6556, Feb. 26, 1992]

§ 7.367(b)–10 Distribution of stock described in section 355.

(a) *Scope.* This section provides rules relating to a distribution described in

section 355 to which section 367(b) applies. For purposes of this section, the terms ''distributing corporation'' and ''controlled corporation'' have the meaning of those terms as used in section 355.

(b) *Distribution by a domestic corporation.* If a domestic corporation distributes stock in a controlled corporation which is a controlled foreign corporation as to which the distributing corporation is a United States shareholder, section 1248(f) applies to such distribution. After earnings and profits attributable to the stock have been determined under section 1248(f), paragraphs (d) through (f) of this section apply. With respect to subsequent transactions involving the distributing group, the allocation described in paragraph (d) of this section shall not increase or decrease the amounts described in paragraphs (d) through (g) of § 7.367(b)–2.

(c) *Distribution of stock by a foreign corporation.* If a foreign corporation having a United States shareholder distributes stock in another corporation, paragraphs (d) through (j) of this section apply.

(d) *Allocation of earnings and profits.* Earnings and profits or deficit accumulated or incurred by the distributing corporation, the controlled corporation (or corporations), and by corporations which directly or indirectly are controlled by either, shall be allocated among those corporations immediately after the distribution. For purposes of making this allocation:

(1) Section 1.312–10 shall not apply.

(2) The sum of the earnings and profits accumulated prior to the distribution by each corporation shall be determined.

(3) The sum of the deficits in earnings and profits incurred prior to the distribution by each corporation shall be determined.

(4) The total gross earnings and profits and deficits shall be allocated between the distributing corporation and any corporations controlled by it after the distribution (the ''distributing group'') and the controlled corporation (or corporations) and any corporations controlled by them after the distribution (the ''controlled group''). Such allocation shall be made in accordance with the net fair market value of the assets of each group. In determining the fair market value of the assets of a group, the fair market value of stock in a corporation controlled by another corporation in a group shall not be taken into account.

(5) For purposes of allocating earnings and profit or deficits to either the distributing group or the controlled group:

(i) Earnings and profits or deficit of only the distributing corporation or of the controlled corporation shall be increased;

(ii) No allocation shall be made from one member to another member of the same group;

(iii) The earnings and profits allocated from a particular corporation shall be the proportion of total earnings and profits allocated from its group to the other group which earnings and profits of that particular corporation prior to the allocation bears to the total gross earnings and profits of all corporations in that group having earnings and profits prior to the allocation; and

(iv) The deficit in earnings and profits allocated from a particular corporation shall be the proportion of the total deficits allocated from its group to the other group which the deficit of that particular corporation prior to the allocation bears to the total gross deficit of all corporations in that group having deficits prior to the allocation.

(6) To the extent that there is not distributed all the stock of the controlled corporation, or of any lower-tier corporation of the controlled corporation whose earnings and profits would be taken into acccount in calculating a section 1248(c)(2) amount, paragraph (d) (1) through (5) of this section shall apply only to the proportion of the earnings and profits or deficits attributable to the stock distributed. Such proportion shall be determined as if the earnings and profits were section 1248 or section 1248(c)(2) amounts. The earnings and profits or deficits not allocated by reason of this paragraph shall be considered entirely attributable to the stock not distributed.

(e) *Adjustment to basis.* (1) Except as provided in paragraph (f) of this section, to the extent earnings and profits

are allocated from a corporation other than the distributing or controlled corporations, the basis of the stock of that corporation in the hands of its immediate shareholder shall be increased by the amount of earnings and profits allocated from it and from members of the group which as to that corporation are lower-tier corporations. Correspondingly, to the extent deficits are allocated from a corporation other than the distributing or controlled corporation, the basis of the stock of that corporation in the hands of its immediate shareholder shall be decreased by the amount of deficit allocated from it and from members of the group which as to that corporation are lower-tier corporations.

(2) Any adjustment to basis in respect of earnings and profits or deficit accumulated or incurred in taxable years beginning before January 1, 1963, shall be taken into account only for purposes of computing the all earnings and profits and additional earnings and profits amounts.

(f) *Election as condition of increase in basis.* An increase in basis attributable to allocation of earnings and profits for taxable years beginning after December 31, 1962, of a corporation to the other group shall be made only if all United States shareholders of the group from which the allocation is made (determined after the distribution) make a consent dividend election in the notice required by paragraph (c) of § 7.367(b)–1. If such consent is made, such earnings and profits, allocated from each particular corporation shall be treated as if, immediately after the distribution, they had been distributed as a dividend through any intervening corporations to the distributing corporation or controlled corporation as the case may be. See sections 553, 951, and 959 for the possible effect of an election under this section.

(g) *Computation of certain amounts.* Upon a distribution described in paragraph (c) of this section, the section 1248 or section 1248(c)(2) amount, the all earnings and profits amount, and the additional earnings and profits amount shall be computed with respect to each United States shareholder and to each foreign corporation as to which there is a United States shareholder. The computation shall be made with reference to stock owned by the shareholder in the distributing corporation prior to the distribution and shall be made regardless of whether the shareholder is an exchanging shareholder.

(h) *Attribution to stock owned after the distribution.* (1) The amounts described in paragraph (g) of this section shall be attributed to all stock owned after the distribution except stock owned after the distribution except stock received in the distribution and to which paragraph (i) or (j) or this section applies.

(2) Attribution of an amount shall be made to stock of a corporation in the proportion that the value of such stock bears to all stock owned after the distribution, including for this purpose stock to which paragraph (i) or (j) of this section applies and to which no attribution is made.

(3) If after the distribution the distributing foreign corporation is no longer controlled foreign corporation as to a United States shareholder, see section 1248(a)(2) with respect to stock disposed of within five years after a change in status.

(i) *Receipt of other stock.* Except as provided in paragraph (j) of this section, if an exchanging shareholder receives—

(1) Stock of a domestic corporation,

(2) Stock of a foreign corporation which is not a controlled foreign corporation, or

(3) Stock of a controlled foreign corporation as to which the exchanging United States shareholder or any United States shareholder of the exchanging foreign corporation is not a United States shareholder, then—

(i) An exchanging United States shareholder shall include in gross income the excess of—

(A) The section 1248 amount computed under paragraph (g) of this section, over

(B) The section 1248 amount attributed to stock under paragraph (h) of this section,

to the extent that the fair market value of stock in the distributing corporation owned by the shareholder prior to the distribution exceeds its adjusted basis; or

(ii) There shall be added to the earnings and profits or deficit of an exchanging foreign corporation the excess of;

(A) The section 1248(c)(2) amount computed under paragraph (g) of this section, over

(B) The section 1248(c)(2) amount attributed to stock under paragraph (h) of this section. The amount added shall not be considered a dividend.

(C) In situations to which subdivision (B) of this subparagraph applies, the basis adjustment and election rules of §7.367(b)–7(c)(1)(iii) shall apply.

(j) *Receipt of stock by certain domestic corporations.* A United States person shall include in its gross income the excess of the all earnings and profits amount computed under paragraph (g) of this section over the all earnings and profits amount attributed under paragraph (h) of this section if—

(1) The distribution is made pursuant to a reorganization described in section 368(a)(1)(D) and involving the acquisition of assets of the foreign distributing corporation by a domestic corporation; and

(2) The United States person is a domestic corporation.

If the domestic corporation does not include this amount in gross income, for purposes of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the applicable provisions of the Code other than section 35, 356, or 361 shall apply as if the foreign corporation were considered a corporation. For example, sections 358 and 362, if applicable, shall apply as if no gain had been recognized.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65161, Dec. 30, 1977]

§7.367(b)–11 Deficit in earnings and profits.

(a) *Scope.* This section provides rules relating to the manner in which a deficit in earnings and profits of a corporation may be used after certain exchanges to which section 367(b) applies.

(b) *Limitation on deficits allocated to a corporation.* Any deficit in earnings and profits incurred prior to the distribution which are allocated to a corporation under paragraph (c) of §7.367(b)–9 or allocated under paragraph (d) of §7.367(b)–10 shall be used only in the manner prescribed under section 381(c)(2)(B) and the regulations thereunder.

(c) *Deficit in earnings and profits.* If section 382 would apply to a net operating loss of a corporation in respect of a transaction to which section 367(b) applies, the percentage reduction provided in section 382 with respect to net operating losses shall reduce a deficit in earnings and profits allocated to that corporation.

(d) *Computation of allocated amounts.* If paragraph (c) of this section applies, a deficit attributed to stock under §§7.367(b)–5 through 7.367(b)–11 shall be adjusted in accordance with the rule of paragraph (b).

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65162, Dec. 30, 1977]

§7.367(b)–12 Subsequent treatment of amounts attributed or included in income.

(a) *Application.* This section applies to distributions with respect to, or a disposition of, stock—

(1) To which an amount has been attributed pursuant to §7.367(b)–9, or §7.367(b)–10; or

(2) In respect of which an amount has been included in income or added to earnings and profits pursuant to §7.367(b)–7 or §7.367(b)–10.

(b) *Successor in interest.* A subsequent United States shareholder of stock to which this section applies—

(1) Whose holding period is considered to include the period during which such stock was held by the prior United States shareholder, and

(2) Who acquired the stock other than by means of a transfer to which §§7.367(b)–1 through 7.367(b)–12 apply,

shall be considered to be the ''successor in interest'' to the prior United States shareholder. The successor in interest will succeed to the earnings and profits or deficit which the regulations under section 367(b) attribute to the stock in the hands of the prior United States shareholder.

(c) *Distributions after attribution.* Distributions with respect to stock made after an amount has been attributed to

the stock under § 7.367(b)–9 or § 7.367(b)–10 shall be considered to be made in accordance with the following rules:

(1) Distributions shall be considered to be made first out of earnings and profits accumulated since the attribution.

(2) To the extent that as of the close of a taxable year distributions have exceeded earnings and profits accumulated since the attribution, excess distributions during that years shall be considered to be made out of earnings and profits previously attributed to the stock (but will not increase a deficit attributed to the stock). Solely for this purpose, amounts which would have been attributed to stock under § 7.367(b)–9 or § 7.367(b)–10 had such stock been owned by a United States shareholder or by an exchanging foreign corporation as to which there is a United States shareholder shall be attributed to such stock.

(3) Distributed earnings and profits considered under paragraph (c)(2) of this section to be made out of attributed amounts shall be considered as if distributed from each of the corporations from which amounts have been attributed, in the proportion that amounts attributed from that corporation bear to amounts attributed from all corporations from which amounts have been attributed. Such amounts shall retain their character for all purposes, including sections 901 through 908 and 959.

(4) When all earnings and profits attributed have been distributed, the distributions shall be considered to have been made from earnings and profits accumulated by the distributing corporation, whether before or after the attribution.

(d) *Distributions after an inclusion in income or addition to earnings and profits.* Amounts included in gross income of a United States person pursuant to § 7.367(b)–7 or § 7.367(b)–10 shall be treated for purposes of this section in the same manner as amounts previously included in income under section 951. Thus—

(1) Subsequent distributions of amounts which would but for this section be treated as dividends shall be considered first to consist of amounts previously included in income and shall be excluded in the same manner as under section 959.

(2) In the case of an inclusion under § 7.367(b)–10, this paragraph shall apply only with respect to distributions from the corporations described in paragraph (i) or (j) of that section.

(3) Amounts of which an election applies under § 7.367(b)–7(c)(1)(iii) or § 7.367(b)–10(i)(3)(ii)(C) shall be treated in the same manner as amounts described in paragraph (d)(1) of this section but only to the extent distributed to the exchanging foreign shareholder.

(e) *Disposition after an attribution or inclusion in income.* Upon a disposition of stock to which section 1248 or § 7.367(b)–1 through § 7.367(b)–12 apply, amounts described in § 7.367(b)–2 (d) through (g) shall be determined in the following manner:

(1) In the case of amounts to which a corporation succeeds under section 381(a)(1), the rules of section 1248 will apply.

(2) In the case of amounts attributed under §§ 7.367(b)–9 and 7.367(b)–10:

(i) There shall first be determined earnings and profits or deficits attributed to the stock disposed of,

(ii) The earnings and profits described in paragraph (e)(2)(i) of this section shall be reduced (but deficits shall not be increased) by distributions referred to in paragraph (c)(2) of this section.

(iii) To the amount determined after applying paragraph (e)(2)(ii) of this section there shall be added amounts attributable to the stock without regard to the attribution; however, earnings and profits or deficits accumulated or incurred prior to the attribution shall not be taken into account.

Moreover, deficits incurred after the attribution shall not be taken into account to the extent they would occur by reason of distributions of previously attributed earnings and profits. For example, distributions described in paragraph (c)(2) of this section shall not be taken into account in computing a deficit under § 1.1248–3(b)(3); and no part of any deficit attributable to distributions described in paragraph (c)(2) of this section shall be allocated to stock until after the earnings and profits previously attributed have been distributed.

(iv) Amounts to which paragraph (d)(1) or (d)(3) of this section apply shall increase the basis of stock in the same manner as under section 961, and distributions attributable to those amounts shall correspondingly decrease the basis of stock.

(v) Earnings and profits distributed out of accumulated amounts shall be considered as if distributed from each of the corporations from which earnings and profits have been attributed, in the ratio that earnings and profits attributed from that corporation bear to earnings and profits attributed from the corporations from which earnings and profits have been attributed. Such distributions shall reduce the amounts previously attributed and shall retain their character for all purposes, including sections 901 through 908 and section 959.

(vi) When all attributed amounts have been distributed, the distributions shall be considered to have been made from earnings and profits accumulated by the distributing corporation, whether before or after the distribution.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65163, Dec. 30, 1977]

§ 7.367(b)–13 Examples.

The following examples illustrate the application of §§ 7.367(b)–1 through 7.367(b)–12, inclusive. Unless otherwise indicated, no foreign corporation in any of these examples is a person referred to in section 6012.

Example (1). F, F1, and F2 are foreign corporations that were organized on January 1, 1960. At all times since this date, A, a domestic corporation, has owned 100 percent of the outstanding stock in F, F has owned 100 percent of the outstanding stock in F1, and F1 has owned 100 percent of the outstanding stock in F2. A, F, F1, and F2 each uses the calendar year as its taxable year. For each taxable year since their date of organization, F, F1, and F2 each has earnings and profits of $1,000. None of these earnings and profits is of a character described in section 1248(d). On January 1, 1980, F1 is liquidated into F in an exchange to which section 332 would apply if the status of F and F1 as corporations is recognized. A complies with the reporting requirements of § 7.367(b)–1(c) (with respect to the foreign personal holding company income realized by F on the liquidation).

Under § 7.367(b)–5(c), F and F1 are considered to be corporations for purposes of section 332 and other applicable sections. Under section 381(a)(1), F succeeds to F1's $20,000 of earnings and profits. These earnings and profits are considered to have been accumulated by F and retain their character as provided in § 7.367(b)–3(e) (*e.g.*, $3,000 retains its character as pre-1963 earnings and profits). F's basis in the stock in F2 received in the liquidating distribution is determined under section 334(b)(1).

Example (2). After the completion of the transaction in example (1), F has earnings and profits of $2,000 for its taxable year 1980, which, when added to the $20,000 of earnings and profits previously accumulated by F and the $20,000 of earnings and profits accumulated by F1 to which F succeeded under section 381(a)(1), gives a total of $42,000. F2 has earnings and profits of $1,000 for its taxable year 1980, giving F2 a total of $21,000 of earnings and profits. A's basis in its stock in F is $25,000.

(a) On January 1, 1981, A sells all its stock in F to an unrelated person for $100,000 in a transaction to which section 1248(a) applies. A recognizes gain of $75,000 ($100,000 − $25,000) on this sale.

As provided in § 7.367(b)–12(e)(1), the rules of section 1248 apply in determining the portion of gain recognized by A that must be treated as a dividend. Under section 1248 and the regulations thereunder, the gain recognized by A must be treated as a dividend to the extent of the earnings and profits of F and F2 attributable to A's stock in F which were accumulated in taxable years beginning after December 31, 1962. The earnings and profits of F1 to which F succeeded under section 381(a)(1) by reason of the transaction in example (1) are considered to have been accumulated by F under § 7.367(b)–3(e). The earnings and profits of F1 accumulated in taxable years beginning before January 1, 1963, retain their character as pre-1963 earnings in the hands of F. Thus, the earnings and profits attributable to A's stock in F (the ''section 1248 amount'') total $54,000. This total consists of $19,000 actually accumulated during taxable years of F ($22,000 − $3,000 of pre-1963 earnings and profits), $18,000 actually accumulated during taxable years of F2 ($21,000 − $3,000 of pre-1963 earnings and profits) and $17,000 of the earnings and profits of F1 to which F succeeded under section 381(a)(1) by reason of the transaction in example (1) ($20,000 − $3,000 of pre-1963 earnings and profits). For its taxable year 1981, A must include in its gross income $54,000 as a dividend and $21,000 ($75,000 gain − $54,000) as capital gain.

(b) On January 1, 1981, instead of A selling the stock of F as in example (2)(a), F is liquidated into A in an exchange to which section 332 would apply if the status of F as a corporation is recognized. F's basis in its assets is $20,000.

The all earnings and profits amount of A with respect to F is $42,000. This amount includes $20,000 of the earnings and profits of F1 to which F succeeded under section 381(a)(1) by reason of the transaction in example (1) since, under § 7.367(b)–3(e), the $20,000 is considered as if accumulated by F. It also includes the $22,000 actually accumulated during taxable years of F. As provided in § 7.367(b)–2(f) and (h)(1), however, it does not include the $21,000 of earnings and profits of F2. A complies with the reporting requirements of § 7.367(b)–1 (c).

(i) A includes in gross income for its taxable year 1981 the all earnings and profits amount of $42,000.

The $42,000 included in income is considered to be a dividend as provided in § 7.367(b)–3(b). This amount increases the earnings and profits of A and decreases the earnings and profits of F to zero. Under § 7.367(b)–5(b), F is considered to be a corporation. A's basis in F's assets, determined under section 334(b)(1), is $20,000.

(ii) A does not include the all earnings and profits amount in gross income for its taxable year 1981.

Under § 7.367(b)–5(b), solely for the purpose of determining the extent to which gain is recognized on the exchange, F is not considered to be a corporation, and A must include in gross income $75,000 ($100,000 fair market value of assets received − $25,000 basis in the stock in F). For all other purposes, F is a corporation. Thus, section 1248 applies to A's exchange of its stock in F and $54,000 is included in A's gross income as a dividend and $21,000 is included as capital gain. See example (2)(a). A succeeds to F's earnings and profits under section 381(a)(1). Pursuant to § 7.367(b)–5(b), A's basis in F's assets is $20,000 under section 334(b)(1).

(iii) A makes a computational error in determining the all earnings and profits amount to include in gross income for its taxable year 1981. If A demonstrates that the error was made in good faith and agrees to correct the error, the Commissioner shall conclude under § 7.367(b)–1(b)(2) that F will be considered to be a corporation for purposes of applying section 332.

(c) The facts are the same as in example (2)(b) except that F is a corporation organized under the laws of Puerto Rico, which in all relevant years has met the requirements of section 957(c) or would have met such requirements if the Revenue Act of 1962 had been in effect. Neither F1 nor F2 meets or has ever met the requirements of section 957(c). Of the $4,000 in earnings accumulated by F after December 31, 1977, $450 would not have qualified for the credit of section 936(a) had F been a domestic corporation which met the requirements of section 936(a)(1) and which had elected the credit under that section.

The all earnings and profits amount of A with respect to F is $20,450. This amount includes the $20,000 of earnings and profits to which F succeeded under section 381(a)(1) upon the liquidation of F1. See example (2)(b). This $20,000 retains its character as earnings and profits which do not meet the requirements of section 957(c). Under § 7.367(b)–2(j), the all earnings and profits amount also includes the $450 of earnings and profits accumulated by F, after December 31, 1977, which would not have qualified for the credit of section 936(a).

(i) A includes in gross income for its taxable year 1981, the all earnings and profits amount of $20,450 pursuant to the liquidation of F on January 1, 1981.

The $20,450 included in income is considered to be a dividend as provided in § 7.367(b)–3(b). This amount increases the earnings and profits of A and decreases the earnings and profits of F. A succeeds under section 381(a)(1) to the remaining $21,550 ($22,000+$20,000 − $20,450) of F's earnings and profits. A's basis in F's assets, determined under section 334(b)(1), is $20,000.

(ii) A does not include the all earnings and profits amount in gross income for its taxable year 1981.

Under § 7.367(b)–5(b), solely for the purpose of determining the extent to which gain is recognized on the exchange pursuant to the liquidation of F on January 1, 1981, F is not considered to be a corporation. Thus, A must include in its gross income $75,000 ($100,000 fair market of assets received − $25,000 basis in the stock in F). Section 1248(a) does not apply because F never has been a controlled foreign corporation. See section 957(c). Thus, the entire $75,000 is capital gain. The other consequences of A's election not to include the all earnings and profits amount in gross income are the same as those illustrated in example (2)(b)(ii).

(d) The facts are the same as in example (2)(b) except that, of the $22,000 of earnings and profits actually accumulated during taxable years of F, the $16,000 accumulated in taxable years beginning before January 1, 1976, is of a character described in section 1248(d)(3).

As explained in example (2)(b), the all earnings and profits amount of A with respect to F is $42,000. This amount is not reduced by the $16,000 of earnings and profits of F which are of a character described in section 1248(d)(3). See § 7.367(b)–3(c)(1)(ii). Pursuant to the liquidation of F on January 1, 1981, A includes $42,000 in gross income as provided in § 7.367(b)–5(b). In the notice required under § 7.367(b)–1(c), A elects to treat the $16,000 of earnings and profits of a character described in section 1248(d)(3) as capital gain. See § 7.367(b)–3(d). Thus, of the $42,000, $26,000 is considered to be a dividend under § 7.367(b)–3(b), and the remaining $16,000 is considered to be capital gain.

Example (3). On July 1, 1980, A, a domestic corporation, purchased all the outstanding stock of F, a foreign corporation, from B, an unrelated person, for $5,000. At all times since this date, A has owned all of the outstanding stock in F. A and F each uses the calendar year as its taxable year. On January 1, 1982, F is liquidated into A pursuant to a plan of liquidation adopted on July 15, 1980, in an exchange to which section 332 would apply if the status of F as a corporation is recognized. A complies with the reporting requirements of § 7.367(b)–1(c). On the date of the liquidation, F's assets have an aggregate fair market value of $6,000. No distributions were made with respect to A's stock in F during the period from July 1, 1980, to and including January 1, 1982. A's all earnings and profits amount under § 7.367(b)–2(f) with respect to F is $150, the earnings and profits accumulated by F during this period. None of the these earnings and profits is of a character described in section 1248(d).

(a) A includes in gross income for its taxable year 1982 the all earnings and profits amount of $150.

The $150 included in income is considered to be a dividend as provided in § 7.367(b)–3(b). This amount increases the earnings and profits of A and decreases the earnings and profits of F. Under § 7.367(b)–5(b), F is considered to be a corporation. A's basis in F's assets is determined under section 334(b)(2) and § 1.334–1(c). Thus, A's basis in F's assets is determined by allocating $5,150 (A's basis of $5,000 in the F stock increased, as provided in § 1.334–1(c)(4)(v)(*a*)(2), by F's earnings and profits of $150 for the period between July 1, 1980 and January 1, 1982) among the assets distributed as provided in § 1.334–1(c).

(b) A does not include the all earnings and profits amount in gross income for its taxable year 1982.

Under § 7.367(b)–5(b), solely for the purpose of determining the extent to which gain is recognized on the exchange, F is not considered to be a corporation, and A must include in gross income $1,000 ($6,000 fair market value of assets received − $5,000 basis in the stock in F). For all other purposes, F is a corporation. Thus, section 1248 applies to A's exchange of its stock in F and $150 (the earnings and profits attributable to A's stock in F) is included in A's gross income as a dividend, and $850 ($1,000 − $150) is included as capital gain. Pursuant to § 7.367(b)–5(b), A's basis in F's assets is determined under section 334(b)(2) and § 1.334–1(c). Thus, the basis of these assets will be determined by allocating $5,150 among these assets in the manner described in example (3)(a).

Example (4). F is a foreign investment company (as defined in section 1246(b)) that was organized on January 1, 1960, and uses the calendar year as its taxable year. A, a domestic corporation, has owned all the outstanding stock of F since F's organization. For each of its taxable years, F has $100 of earnings and profits. A's basis in its stock in F is $200. F's basis in its assets is $250.

(a) On January 1, 1980, foreign corporation X, which is not an ''investment company'' within the meaning of section 368(a)(2)(F)(iii), acquires all of A's stock in F. In exchange for this stock, A receives 10 percent of the voting stock in X having a fair market value of $5,000. Section 354 would apply to the exchange of stock by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(B), if the status of F and X as corporations is recognized. A complies with the reporting requirements of § 7.367(b)–1 (c).

Section 7.367(b)–6 does not apply to the exchange because X is a foreign corporation. Section 7.367(b)–7 does not apply because F is a foreign investment company. F and X are considered to be corporations and A does not recognize the gain of $4,800 ($5,000 fair market value of X stock received − $200 basis in F stock exchanged) realized on the exchange. A's stock in X is treated as stock of a foreign investment company held by A throughout the period that A held stock in F. See section 1246(c). A's basis in the stock in X and X's basis in the stock in F are each $200 under sections 358 and 362, respectively.

(b) The facts are the same as in example (4)(a), except that X is a domestic corporation.

A's section 1246 amount with respect to F is $1,700. As provided in section 1246 and §7.367(b)–2(c), this amount takes into account only the earnings and profits of F accumulated in its 17 taxable years beginning after December 31, 1962. Pursuant to the exchange on January 1, 1980, of A's stock in F for stock in X, A, as provided in § 7.367(b)–6(b), includes the Section 1246 amount of $1,700 in gross income for its taxable year 1980 as gain from the sale of an asset which is not a capital asset under § 7.367(b)–3(a)(1). This amount increases the earnings and profits of A but does not decrease the earnings and profits of F. F is considered to be a corporation. As provided in § 7.367(b)–6(d), the $1,700 is treated as gain recognized for purposes of applying sections 358 and 362. Thus, A's basis in the stock in X received in the exchange, as determined under section 358, is $1,900 (A's basis of $200 in the stock in F increased by its $1,700 gain). X's basis in the stock in F acquired in the exchange, as determined under section 362, is $1,900 (the $200 basis of the stock in F in the hands of A increased by A's $1,700 gain).

(c) The facts are the same as in example (4)(b), except that on January 1, 1980, A receives the stock in X (a domestic corporation) pursuant to the acquisition by X of all of F's assets and the liquidation of F, rather than pursuant to the acquisition by X of all of A's stock in F. Section 354 would apply to the exchange of stock in F by A pursuant to the

liquidation of F, and the transaction would qualify as a reorganization described in section 368(a)(1)(C), if the status of F as a corporation is recognized. A's all earnings and profits amount with respect to its stock in F, determined under § 7.367(b)–2(f), is $2,000 ($100 × 20 years beginning with January 1, 1960, the date of organization of F).

(i) Pursuant to § 7.367(b)–6(c)(1), A includes the all earnings and profits amount of $2,000 in gross income for its taxable year 1980.

As provided in § 7.367(b)–3(a), the $1,700 of earnings and profits accumulated in taxable years beginning after December 31, 1962, is included in income as gain from the sale of an asset which is not a capital asset, and the $300 of earnings and profits accumulated in taxable years beginning before January 1, 1963, is included in income as a dividend. These amounts increase the earnings and profits of A but do not decrease the earnings and profits of F. F is considered to be a corporation. A's basis in the stock in X received in the exchange, determined under section 358, is $2,200 (A's basis of $200 in the F stock increased by the $1,700 gain, under § 7.367(b)–6(d), and by the $300 included in income as a dividend, under section 358(a)(1), X's basis in the assets of F acquired in the exchange, determined under section 362, is $250 (F's basis in those assets), since no gain was recognized to F, the transferor. X succeeds to F's earnings and profits under section 381(a)(2).

(ii) A does not include the all earnings and profits amount in gross income as required by § 7.367(b)–6(c)(1).

Under § 7.367(b)–6(c)(2), solely for the purpose of determining the extent to which gain is recognized on the exchange, F is not considered to be a corporation and A must recognize gain of $4,800 ($5,000 fair market value of X stock received − $200 basis in F stock exchanged). For all other purposes, F is a corporation. Thus, section 1246 applies to A's exchange of its stock in F and $1,700 (the section 1246 amount) is included in A's gross income as ordinary income and $3,100 is included as capital gain. As provided in § 7.367(b)–6(c)(2), A's basis in the stock in X received is $200, determined under section 358. X's basis in the assets of F which were acquired is $250, determined under section 362. X succeeds to F's earnings and profits under section 381(a)(2).

Example (*5*). F, F1, and F2 are foreign corporations that were organized on January 1, 1960. At all times since this date, A, a domestic corporation, has owned 60 percent of the outstanding stock of F, and X, a foreign corporation which is unrelated to A and not subject to tax under subtitle A of the Code, has owned 40 percent of the outstanding stock of F. At all times since this date, F has owned 100 percent of the outstanding stock in F1, and F1 has owned 100 percent of the outstanding stock in F2. A, F, F1, and F2 each uses the calendar year as its taxable year.

(a) For each taxable year since their date of organization, F, F1, and F2 each has earnings and profits of $100. For each taxable year beginning with 1963, F has $40 of subpart F income. For each such taxable year, A includes in its income $24 ($40 × 60 percent of the stock in F) by reason of section 951(a)(1)(A). For each of these years, $24 of F's earnings and profits are attributable to amounts thus included in income by A and therefore are of a character described in section 1248(d)(1). None of the earnings and profits of F1 or F2 is of a character described in section 1248(d). A's basis in its stock in F was $324 on January 1, 1960. As of January 1, 1980, A has included $408 ($24 × 17 years beginning with 1963) in gross income as subpart F income. Thus, under section 961(a), A's basis in its stock in F is $732 ($324 + $408) on that date. F's basis in its assets is $250.

On January 1, 1980, foreign corporation Y acquires all the assets of F in return for Y's voting stock. A and X exchange all their stock in F for stock in Y, and F is liquidated. The Y stock received by A has a fair market value of $6,000 so that A realizes gain of $5,268 ($6,000–$732 basis in the F stock exchanged). Section 354 would apply to the exchange of the stock in F by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(C), if the status of F and Y as corporations is recognized.

(i) In the exchange on January 1, 1980, by A of its stock in F, A receives 20 percent of the voting stock in Y. After the exchange Y is a controlled foreign corporation. Since A is a United States shareholder of Y under § 7.367(b)–2(b), the attribution rules of § 7.367(b)–9 apply, as provided in § 7.367(b)–7(b). A's section 1248 amount with respect to F is $3,060. This amount, determined as provided in § 7.367(b)–2 (d) and (i), consists of $1,020 ($100 × 17 years beginning with 1963 × 60 percent of the F stock) of earnings and profits of F, F1, and F2, respectively. Of the $1,020 of earnings and profits of F, $408 ($24 × 17 years beginning with 1963) is of a character described in section 1248(d)(1). A's all earnings and profits amount with respect to F, determined as provided in § 7.367(b)–2(f) and (h)(1), is $1,200 ($100 × 20 years beginning with 1960 × 60 percent of the F stock). A's additional earnings and profits amount with respect to F is $180 ($100 × 3 years ending with 1962 × 60 percent of the F stock).

Under § 7.367(b)–9(b)(1), A's section 1248 amount, A's all earnings and profits amount, and A's additional earnings and profits amount are attributed to the stock in Y which A receives in the exchange. Under § 7.367(b)–9(b)(2) and § 7.367(b)–9(c), the earnings and profits of Y are increased by $6,000 ($2,000 of earnings and profits of F, F1, and F2, respectively). Under § 7.367(b)–9(b)(3) and (d), the earnings and profits of F, F1, and F2,

respectively, are reduced by $2,000. A complies with the reporting requirements of § 7.367(b)–1(c), and Y, F, F1, and F2 comply with the recordkeeping requirements of § 7.367(b)–1(d). F and Y are considered to be corporations and section 354 applies to the exchange of the stock in F by A.

In the notice required under § 7.367(b)–1(c), A makes the consent dividend election provided for in § 7.367(b)–9(f)(1). Thus, the $1,700 of post-1962 earnings and profits of F2 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend through F1 to F. The $1,700 of post-1962 earnings and profits of F1 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend to F. These earnings and profits treated as if distributed must be included in A's gross income to the extent, if any, required under section 551 or 951. If A includes under section 951 its full pro-rata share of the amount treated as distributed, the amount attributed to A's stock in Y which is of a character described in section 1248(d)(1) will be $2,448 ($3,400 × 60 percent of the F stock + $408 of F's earnings and profits which otherwise are of a character described in section 1248(d)(1)).

A's basis in its stock in F immediately prior to the reorganization is increased under section 961(a) by $2,040 from $732 to $2,772. Thus, A's basis in the Y stock received, determined under section 358, is $2,772. In addition, under § 7.367(b)–9(e)(1), the basis of Y's stock in F1 is increased by $4,000 ($600 of pre-1963 earnings and profits + 3,400 of post-1962 earnings and profits), and the basis of F1's stock in F2 is increased by $2,000 ($300 of pre-1963 earnings and profits +$1,700 of post-1962 earnings and profits). However, the increases in respect of pre-1963 earnings and profits are made only for purposes of computing the all earnings and profits amount and the additional earnings and profits amount with respect to subsequent transactions. See § 7.367(b)–9(e)(3).

(ii) In the exchange on January 1, 1980, by A of its stock in F, A receives 5 percent of the voting stock in Y (rather than 20 percent as in example (5)(a)(i)).

Since A is not a United States shareholder of Y as defined in § 7.367(b)–2(b) immediately after the exchange, § 7.367(b)–7(c)(1)(i) applies. A complies with the reporting requirements of § 7.367(b)–1(c). As required by § 7.367(b)–7(c)(1)(i), A includes in gross income for its taxable year 1980 $2,652, which is the section 1248 amount of $3,060 (computed as in example (5)(a)(i)) reduced, as provided in § 7.367(b)–3(c)(1), by the $408 of earnings and profits of F retaining their character as earnings and profits described in section 1248(d)(1). F and Y are considered to be corporations for purposes of applying section 354 to the exchange of the stock in F by A. Accordingly, no gain is recognized by A. Y succeeds to the $2,000 of earnings and profits of F under section 381(a)(2). In addition, A's basis in the stock in Y received in the exchange, determined under section 358, is $3,384 ($732 basis in F stock exchanged + $2,652 included in gross income in the manner provided in section 961). See § 7.367(b)–12(d). Y's basis in the assets of F, determined under section 362, is $250 (F's basis in those assets), since no gain was recognized to F.

Under § 7.367(b)–3 (b) and (f), the foreign tax credit provisions (sections 78 and 901 through 908) apply as if the $2,652 included in gross income by A were actually distributed to A as a dividend immediately before the exchange. A will be deemed to have paid the proportion of the foreign taxes paid or deemed paid by F, F1, and F2, determined as provided in section 902 and the regulations thereunder. For this purpose, the portions of the section 1248 amount included in gross income by A which are attributable, respectively, to F, F1, and F2 are determined as provided in § 7.367(b)–3(g)(1). Thus, $612 ($612 × $2,652/$2,652) is attributable to F and $1,020 ($1,020 × $2,652/$2,652) is attributable to F1 and F2, respectively. (The first factor in the numerator is the section 1248 amount determined as if the corporation in question were the only corporation, and reduced under § 7.367(b)–3(c)(1)(i) by the amount of earnings and profits retaining its character as earnings and profits described in section 1248(d)(1). The second factor in the numerator is the amount included in A's gross income as a dividend. The denominator is the section 1248 amount reduced under § 7.367(b)–3(c)(1)(i) by the amount of earnings and profits retaining its character as earnings and profits described in section 1248(d)(1).) As provided in § 7.367(b)–3(g)(2), the amounts thus determined to be attributable to F1 and F2 are treated as if distributed directly to A by F1 and F2, respectively, for purposes of applying section 902. These amounts increase the earnings and profits of A but do not decrease the earnings and profits of F, F1, or F2.

(b) The facts are the same as in example (5)(a)(ii) except that A's basis in its F stock was $3,824 on January 1, 1960 (rather than $324) and, by reason of section 961(a), is $4,232 ($3,824+$408 earnings and profits of F previously included in A's gross income under section 951(a)(1)(A)) on January 1, 1980. On the exchange on January 1, 1980 of its stock in F for 5 percent of the voting stock in Y, A realizes a gain of $1,768 ($6,000 fair market value of the Y stock received −$4,232 basis in the F stock exchanged).

As required by §§ 7.367(b)–3(c)(1)(i) and 7.367(b)–7(c)(1)(i), A includes in gross income as a dividend the realized gain of $1,768 since that amount is less than $2,652 ($3,060 section 1248 amount−$408 of earnings and profits of F retaining their character as earnings and profits described in section 1248(d)(1)). For the purpose of determining the proportion of the foreign taxes paid or deemed paid by F,

F1, and F2 which A will be deemed to have paid under section 902 and the regulations thereunder, the portions of the amount included in gross income by A which are attributable, respectively, to F, F1, and F2 are determined as provided in § 7.367(b)–3(g)(1). Thus, $408 ($612 × $1,768/$2,652) is attributable to F and $680 ($1,020 × $1,768/$2,652) is attributable to F1 and F2, respectively.

(c) The facts are the same as in example (5)(b), except that, since January 1, 1963, F1 has earnings and profits of $100 for each of five taxable years and deficits of ($100) for each of the other twelve taxable years, and F2 has deficits of ($100) for each of four taxable years and earnings and profits of $100 for each of the other thirteen taxable years (rather than F1 and F2 having earnings and profits of $100 for each taxable year). On the exchange, on January 1, 1980, of its stock in F for 5 percent of the voting stock in Y, A realizes a gain of $1,768 ($6,000 − $4,232) as in example (5)(b). A's section 1248 amount with respect to F is $1,140. This amount, determined as provided in § 7.367(b)–2(d) and (i), consists of $1,020 of earnings and profits of F ($100 × 17 years beginning with 1963 × 60 percent of the F stock), ($420) of deficit of F1 ($100 × 5 profitable years × 60 percent × 100 percent of the F1 stock − ($100) × 12 deficit years × 60 percent × 100 percent), and $540 of earnings and profits of F2 ($100 × 13 profitable years × 60 percent × 100 percent × 100 percent of the F2 stock—($100) X 4 deficit years X 60 percent X 100 percent X 100 percent).

As required by §§ 7.367(b)–3(c)(1)(i) and 7.367(b)–7(c)(1)(i), A includes in gross income as a dividend, $732 ($1,140 section 1248 amount − $408 of earnings and profits retaining its character as earnings and profits described in section 1248(d)(1)). For the purpose of determining the proportion of the foreign taxes paid or deemed paid by F, F1, and F2 which A will be deemed to have paid under section 902 and the regulations thereunder, the portions of the amount included in gross income by A which are attributable respectively to F, F1, and F2 are determined as provided in § 7.367(b)–3(g)(1). (Deficits are disregarded in computing the first factor in the numerator of each fraction. They are not, however, disregarded for any other purpose.) Thus, $612 ($612 × $732/$732) is attributable to F, $500 ($500 × $732/$732) is attributable to F1, and $1,300 ($1,300 × $732/$732) is attributable to F2.

Example (6). On January 1, 1981, one year after the transaction described in example (5)(a)(ii), Y makes a pro-rata distribution of $10,000 with respect to its stock. As of January 1, 1981, Y has $10,000 of earnings and profits, including the $2,000 of F's earnings and profits to which Y succeeded under section 381(a)(2) pursuant to the earlier transaction. None of the $8,000 of earnings and profits actually accumulated by Y is of a character described in section 1248(d). A, which owns the 5 percent of the Y voting stock received in the earlier transaction, receives $500 as its pro-rata share of the distribution from Y.

As provided in § 7.367(b)–12(d), the $2,652 that was included in gross income by A under § 7.367(b)–7 pursuant to the earlier transaction is treated in the same manner as amounts previously included in A's gross income under section 951. By virtue of succeeding to F's earnings and profits, Y has $1,020 of earnings and profits which have previously been included in A's gross income. This amount consists of the $408 of F's subpart F income and the $612 of the section 1248 amount attributable to F which was included in A's gross income pursuant to the earlier transaction. Under § 7.367(b)–12(d)(1), the $500 distributed by Y to A shall be excluded from A's gross income in the same manner as under section 959. A's basis in its stock in Y shall be decreased by $500 in the manner provided in section 961 (b) from $3,384 to $2,884. After the distribution, Y has $520 ($1,020 − $500) of earnings and profits which have previously been included in A's gross income. (F1 and F2 each has $1,020 of such earnings and profits.)

Example (7). On January 1, 1981, one year after the transaction described in example (5)(a)(i), Y makes a pro-rata distribution of $10,000 with respect to its stock. As of January 1, 1981, Y has $10,000 of earnings and profits. This amount consists of the $6,000 of earnings and profits of F, F1, and F2 by which the earnings and profits of Y were increased under § 7.367(b)–9 (b)(2) and (c) pursuant to the earlier transaction, $1,000 actually accumulated by Y after the earlier transaction (in its taxable year 1980), and $3,000 actually accumulated by Y before the earlier transaction. None of the $4,000 of earnings and profits actually accumulated by Y is of a character described in section 1248(d). Pursuant to the earlier transaction, A's section 1248 amount of $3,060, A's all earnings and profits amount of $1,200, and A's additional earnings and profits amount of $180 have been attributed to A's stock in Y under § 7.367(b)–9(b)(1). Of the $3,060 section 1248 amount so attributed, $408 of the earnings and profits from F (A's pro-rata share of the subpart F income actually derived by F), and $1,020 of the earnings and profits from F1 and F2, respectively (pursuant to the § 7.367(b)–9(f)(1) consent dividend election), are of a character described in section 1248(d)(1).

Since the amount of the distribution does not exceed Y's earnings and profits (including the earnings and profits of F, F1, and F2 by which the earnings and profits of Y were increased), the entire distribution is a dividend except to the extent provided in § 7.367(b)–12. A, which owns 20 percent of the Y voting stock received in the earlier transaction, receives $2,000 as its pro-rata share of the distribution from Y. Under § 7.367(b)–12(c), this distribution is considered to be

made first out of $200 of the $1,000 of earnings and profits accumulated by Y since the attribution pursuant to the earlier transaction and is a dividend to A. The remaining $1,800 is considered to be made out of the earnings and profits attributed to A's stock in Y. Under § 7.367(b)–12(c)(3), $600 of this $1,800 is considered as if distributed from the earnings and profits of F, F1, and F2, respectively ($1,800 × $1,020 of section 1248 amount attributed from each corporation/$3,060 section 1248 amount attributed to A's stock in Y). These amounts retain their character as amounts described in section 1248(d)(1). Since $408 of the earnings and profits attributed from F, and all $1,020 of the earnings and profits attributed from F1 and F2, respectively, are of such a character, only $192 [($600 − $408) + ($600 − $600) + ($600 − $600)] of the $1,800 distributed out of attributed earnings and profits is considered to be a dividend. the $1,608 ($408 + $600 + $600) distribution of earnings and profits of a character described in section 1248(d)(1), which otherwise would be treated as a dividend, is excluded from gross income under section 959. Thus, $392 of the $2,000 distributed to A is considered to be a dividend, of which $200 is from earnings and profits of Y for its taxable year 1980 and $192 is from earnings and profits accumulated by F prior to its acquisition by Y.

A's basis in its stock in Y is reduced, under section 961(b), by the $1,608 excluded from gross income under section 959(a) from $2,772 to $1,164. A's section 1248 amount attributed to its stock in Y is reduced, under § 7.367(b)–12(c)(2), by $1,800 from $3,060 to $1,260, of which $840 [($1,020 − $600) + ($1,020 − $600)] is of a character described in section 1248(d)(1). A's all earnings and profits amount is reduced from $1,200 to $600, none of which is of a character described in section 1248(d)(1). A's additional earnings and profits amount is not affected by the distribution. See section 316.

Example (8). On January 1, 1982, 2 years after the transaction described in example (5)(a)(i), and 1 year after the distribution described in example (7), A sells all its stock in Y for $7,000 realizing a gain of $5,836 ($7,000 − $1,164). During 1981, Y had $1,000 of earnings and profits. Under § 7.367(b)–12(e), the section 1248 amount attributable to A's stock in Y is $1,460. This amount consists of $200 of the $1,000 of Y's earnings and profits for 1981 (A owns 20 percent of the stock in Y), plus the $3,060 section 1248 amount attributed to A's stock in Y, reduced as provided in § 7.367(b)–12(e)(2)(ii) by the $1,800 considered distributed in example (7) out of the section 1248 amount so attributed. (See § 7.367(b)–12(c)(2).) Of this section 1248 amount of $1,460, the $840 [($1,020 − $600) + ($1,020 − $600)] of the earnings and profits attributed from F1 and F2 that remain after the distribution described in example (7) are of a character described in section 1248(d)(1). Thus, $620 ($1,460 Section 1248 amount −$840 section 1248(d)(1) earnings and profits) of the gain on the sale of the Y stock is treated as a dividend under section 1248(a) and the remaining $5,216 ($5,836 − $620) is recognized as capital gain.

Example (9). F, F1, F2, and F3 are foreign corporations that were organized on January 1, 1975. At all times since this date, A, a domestic corporation, has owned 60 percent of the outstanding stock in F, and X, a foreign corporation unrelated to A and not subject to tax under subtitle A of the Code, has owned 40 percent of the outstanding stock in F. At all times since this date, F has owned 100 percent of the outstanding stock in F1, F1 has owned 100 percent of the outstanding stock in F2, and F2 has owned 100 percent of the outstanding stock in F3. A, F, F1, F2, and F3 each uses the calendar year as its taxable year. For each taxable year since their date of organization, F, F1, and F3 each has earnings and profits of $100. For each taxable year since its date of organization, F2 has a deficit of ($100). None of the earnings and profits of F, F1, or F3 is of a character described in section 1248(d). A's basis in its stock in F is $620.

On January 1, 1980, A and X exchange all of their stock in F. As sole consideration for the stock exchanged, A receives 20 percent of the voting stock in foreign corporation Y, and X receives 13.3 percent of the voting stock in Y. The Y stock received by A has a fair market value of $4,000. Section 354 would apply to the exchange of stock in F by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(B), if the status of F and Y as corporations is recognized. After the transaction, Y is a controlled foreign corporation but is not a foreign personal holding company.

A realizes gain of $3,380 ($4,000 fair market value of the Y stock received—$620 basis in the F stock exchanged). Since A owns 20 percent of the voting stock in Y immediately after the exchange, A is a United States shareholder of Y as defined in § 7.367(b)–2(b). Accordingly, the attribution rules of § 7.367(b)–9 apply, as provided in § 7.367(b)–7(b)(1). Under § 7.367(b)–9(b)(1), A's section 1248 amount of $600 is attributed to the stock in Y which A received in the exchange. This amount consists of $300 of earnings and profits of F, F1, and F3, respectively ($100×5 years×60 percent of the stock in F), and ($300) of deficit of F2 (($100)×5 years×60 percent). Under § 7.367(b)–9(b)(2) and § 7.367(b)–9(c), the earnings and profits of Y are increased by $1,500 ($500 of earnings and profits of F, F1 and F3, respectively). Any deficit of Y is increased by the ($500) deficit of F2, subject to § 7.367(b)–11, relating to the manner in which such deficit may be used. These earnings and profits and deficit retain their character as provided in § 7.367(b)–3(e). Under § 7.367(b)–

9(b)(3) and § 7.367(b)–9(d), the earnings and profits of F, F1, and F3, and the deficit of F2 are each correspondingly reduced by $500. A complies with the reporting requirements of § 7.367(b)–1(c), and Y, F, F1, F2, and F3 comply with the recordkeeping requirement of § 7.367(b)–1(d). F and Y are considered to be corporations and section 354 applies to the exchange of stock by A. A's basis in the stock in Y determined under section 358 is $620.

(a) In the notice required under § 7.367 (b)–1(c), A does not make the consent dividend election provided for § 7.367 (b)–9(f)(1).

Under § 7.367–9(e)(1), F1's basis in its stock in F2 and F's basis in its stock in F1 are each reduced by $500. These reductions are made on account of the $500 reduction in F2's deficit. Since A did not make the election under § 7.367(b)–9(f)(1), no basis adjustment on account of F1 and F3's earnings and profits is permitted under § 7.367(b)–9(e)(1). Under § 7.367(b)–9(e)(2), Y's basis in its stock in F is reduced by $500 on account of the $500 reduction F2's deficit. Since A did not make the election under § 7.367(b)–9(f)(1), no adjustment to Y's basis in F is permitted on account of earnings and profits accumulated in taxable years beginning after December 31, 1962, even if the election provided for in § 7.367(b)–9(f)(2)(ii) is made. See § 7.367(b)–9(f)(2). Thus, Y's basis in its F stock, determined under section 362 and § 7.367(b)–9(e), is $120 ($620–$500).

(b) The facts are the same as in example (9)(a), except that in the notice required under § 7.367(b)–1(c), A makes the consent dividend election provided for in § 7.367(b)–9(f)(1). In addition, all the United States shareholders of Y make a consent dividend election as provided in section 565 for 1980 (the taxable year in which the reorganization occurred). See § 7.367(b)–9(f)(2)(ii).

Under § 7.367(b)–9(f)(1), the $500 of earnings and profits of F3 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend through F2 and F1 (unreduced by the deficit of F2) to F. The $500 of earnings and profits of F1 is treated as if, immediately prior to the reorganization, it had been distributed as a dividend to F. Accordingly, under § 7.367(b)–9(e)(1), F2's basis in the F3 stock is increased by $500; F1's basis in the F2 stock is decreased by the ($500) deficit from F2 (see example (9)(a)) and increased by the $500 of earnings and profits from F3 for a net adjustment of zero; and F's basis in the F1 stock is decreased by the ($500) deficit from F2 (see example (9)(a)) and increased by the $1,000 of earnings and profits from F3 and F1 for a net increase of $500. For the consequences to A of making the consent dividend election provided for in § 7.367(b)–9(f)(1), see example (5)(a).

Under § 7.367(b)–9(f)(2), the $500 of earnings and profits of F3 is treated as if, immediately after the reorganization, it had been distributed as a dividend through F2, F1 and F (unreduced by the deficit of F2) to Y. The $500 of earnings and profits of F1 is treated as if, immediately after the reorganization, it had been distributed as a dividend through F to Y. The $500 of earnings and profits of F is treated as if, immediately after the reorganization, it had been distributed as a dividend to Y. Accordingly, under § 7.367(b)–9(e)(2), Y's basis in the F stock is increased by the $1,500 total of the earnings and profits treated as if distributed to Y and is decreased by the ($500) deficit of F2 (see example (9)(a)). Thus, the net increase in Y's basis in the F stock is $1,000 and this basis, determined under section 362 and § 7.367(b)–9(e), is $1,620 ($620 + $1,000). For the consequences to the United States shareholders of Y of the consent dividend to Y, see sections 951 and 959.

Example (10). F, F1, and F2 are foreign corporations that were organized on January 1, 1975. At all times since this date, A, a domestic corporation, has owned 100 percent of the outstanding stock in F, F has owned 90 percent of the outstanding stock in F1, X, a foreign corporation unrelated to A and not subject to tax under subtitle A of the Code, has owned 10 percent of the outstanding stock in F1, and F1 has owned 100 percent of the outstanding stock in F2. F, F1, and F2 each uses the calendar year as its taxable year. For each taxable year since their date of organization, F, F1, and F2 each has earnings and profits of $100. None of the earnings and profits of F, F1, or F2 is of a character described in section 1248(d). F's basis in its stock in F1 is $620.

On January 1, 1980, F exchanges all of its stock in F1. X retains its stock in F1. As sole consideration for the stock exchanged, F receives 20 percent of the voting stock in foreign corporation Y. The Y stock received by F has a fair market value of $4,000. Section 354 would apply to the exchange of the stock in F1 by F, and the transaction would qualify as a reorganization described in section 368(a)(1)(B), if the status of F1 and Y as corporations is recognized. After the transaction Y is a controlled foreign corporation. Y uses the calendar year as its taxable year.

F realizes gain of $3,380 ($4,000 fair market value of the Y stock received—$620 basis in the F1 stock exchanged). Since A is a United States shareholder of Y after the exchange, the attribution rules of § 7.367(b)–9 apply, as provided in § 7.367(b)–7(b). Under § 7.367(b)–9(b)(1), A's section 1248(c)(2) amount of $900 is attributed to the stock in Y which F receives in the exchange. This amount consists of $450 ($100 × 5 years × 90 percent of the stock in F1) of the earnings and profits of F1 and F2, respectively. The earnings and profits of Y are increased by the $450 of earnings and profits of F1 and the $450 of earnings and profits of F2, in accordance with §§ 7.367(b)–9(b)(2) and

7.367(b)–9(c). The earnings and profits of F1 and F2, respectively, are correspondingly reduced by $450 under §§7.367(b)–9(b)(3) and 7.367(b)–9(d). In addition, under § 7.367(b)–9(c)(2), the $50 of earnings and profits of F1 and F2, respectively, which do not increase the earnings and profits of Y, is considered to be entirely attributable to the stock not acquired by Y (*i.e.,* the stock owned by X). A complies with the reporting requirements of § 7.367(b)–1(c), and Y, F, F1, and F2 comply with the recordkeeping requirements of § 7.367(b)–1(d). F1 and Y are considered to be corporations and section 354 applies to the exchange of F1 stock by F.

In the notice required in § 7.367(b)–1(c), A does not make the consent dividend election provided for in § 7.367(b)–9(f)(1). Accordingly, no adjustment to basis is made under § 7.367(b)–9(e).

Example (11). On January 1, 1981, after the transaction described in example (10), A sells all its stock in F. In taxable year 1980, Y, F, F1, and F2 each has $100 of earnings and profits. Upon A's sale of its stock in F, A's section 1248 amount is $1,556. This amount consists of $600 of earnings and profits of F ($100 × 6 years beginning with 1975 × 100 percent of the stock in F) under section 1248(a), and, under § 7.367(b)–12(e)(2), the section 1248(c)(2) amount of $900 attributed to the stock in Y received by F pursuant to the earlier transaction, $20 of earnings and profits accumulated by Y in 1980 ($100 × 100 percent × 20 percent of the stock in Y), and $18 of earnings and profits accumulated by F1 and F2, respectively, in 1980 ($100 × 100 percent × 20 percent × 90 percent of the stock in F1).

Example (12). On December 31, 1980, after the transaction described in example (10), F1 makes a pro-rata distribution of $180, no part of which is subpart F income, to Y and X. Without regard to this distribution Y, F, F1, and F2 each has $100 of earnings and profits in 1980. On December 31, 1980, F1 has $100 of current earnings and profits and $50 of accumulated earnings and profits ($500 accumulated between 1975 and 1979—$450 by which the earnings and profits of F1 were reduced pursuant to the transaction in example (10)). Thus, $135 ($150 × 90 percent of the stock in F1) of the distribution to Y is a dividend. Y's basis in the stock in F1 is reduced under section 301(c)(2) by $27.

On January 1, 1981, A sells all its stock in F. Upon this sale, A's section 1248 amount is $1,565. This amount consists of $600 of earnings and profits of F ($100 × 6 years beginning with 1975 × 100 percent of the stock in F), the section 1248(c)(2) amount of $900 attributed to the stock in Y received by F pursuant to the earlier transaction, $47 of the $235 of earnings and profits accumulated by Y in 1980 ($100 plus the $135 dividend from F1) and $18 of the $100 of earnings and profits accumulated by F2 in 1980. (After the $180 distribution, F1 has no earnings and profits attributable to the stock in F sold by A. See §§ 1.1248–2(d)(1) and 1.1248–3(b)(3).)

Example (13). On December 31, 1980, after the transaction described in example (10), Y sells all its stock in F1 and recognizes gain of $1,200. Without regard to this sale, Y, F, F1, and F2 each has $100 of earnings and profits in 1980. On January 1, 1981, A sells all its stock in F. Upon this sale, A's section 1248 amount is $1,760. This amount consists of $600 of earnings and profits of F, the section 1248(c)(2) amount of $900 attributed to the stock in Y received by F pursuant to the earlier transaction, and $260 of the $1,300 of earnings and profits accumulated by Y in 1980 ($100 plus the $1,200 gain on the sale of the stock in F1). (The earnings and profits accumulated by F1 and F2 in 1980 have been otherwise taken into account under section 1248, within the meaning of section 1248(c)(2)(C), by virtue of the inclusion in Y's earnings and profits of Y's gain on the sale of the stock in F1.)

Example (14). (a) F is a foreign corporation that was organized in country C on January 1, 1978. At all times since that date, A, a domestic corporation, has owned 100 percent of the outstanding stock of F. All of F's assets are used in a manufacturing business. The F stock does not comprise substantially all of A's assets. On January 1, 1983, A exchanges all of its stock of F for 80 percent of the outstanding voting stock of Y, an unrelated foreign corporation organized in country C. At the time of the exchange, A's Y stock received in the exchange has a fair market value of $600, A's adjusted basis in its F stock is $300, and A's section 1248 amount attributable to its F stock is $200. The exchange of stock of F by A would be described in section 351 if the status of Y as a corporation is recognized. This exchange would also be described in section 354 (a reorganization described in section 368(a)(1)(B)) if the status of F and Y as corporations is recognized. Under § 7.367(b)–4(b)(1)(i)(A), the exchange is considered to be one to which § 7.367(b)–7 applies. Under § 7.367(b)–7(b), the exchange is treated as one to which § 7.367(b)–9 applies, and under that latter section the section 1248 amount of $200 must be attributed to the Y stock received in the exchange. If § 7.367(b)–4(b)(2)(i) or (ii) did not apply, then under § 7.367(b)–4(b)(1)(i)(B), A would have to include $100 in gross income as gain from the exchange of the F stock. This amount is equal to the excess of the gain realized, or $300 ($600 minus $300), over the section 1248 amount taken into account under § 7.367(b)–4(b)(1)(i)(A), or $200. However, since Y is a controlled foreign corporation after the transfer and since A is a United States shareholder (within the meaning of § 7.367(b)–2(b)) of F both before and after the transfer and of Y after the transfer, by reason of § 7.367(b)–4(b)(2)(ii) no gain is recognized on the transfer under § 7.367(b)–4(b)(1)(i)(B), but

the section 1248 amount of $200 must be attributed to the Y stock received in the exchange under § 7.367(b)–4(b)(1)(i)(A).

(b) The facts are the same as in paragraph (a) of this example, except that A receives only 30 percent of the Y stock, unrelated foreign persons receive an additional 50 percent of the Y stock in exchange for their contribution of property to Y, and Y is not a controlled foreign corporation after the exchange. Under § 7.367(b)–7(c)(1)(i), A must include in gross income the $200 section 1248 amount attributable to the F stock exchanged. Unless § 7.367(b)–4(b)(2)(i) applies, under § 7.367(b)–4(b)(1)(i)(B) of this section, A must also include $100 in gross income as gain from the exchange of the F stock.

(c) The facts are the same as in paragraph (b) of this example, except that under § 7.367(b)–4(b)(2)(i)(A), A receives a favorable ruling that the exchange is not considered to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. As a result, A is only required to include in gross income the $200 section 1248 amount determined pursuant to § 7.367(b)–4(b)(1)(i)(A) and is not required to include in gross income the $100 determined pursuant to § 7.367(b)–4(b)(1)(i)(B).

(d) The facts are the same as in paragraph (a) of this example, except that A owns only five percent of the outstanding F stock, B (an unrelated domestic corporation) owns 75 percent of the outstanding F stock, and both A and B exchange their F stock for 5 and 75 percent, respectively, of the outstanding stock in Y. Although A is a United States person at the time of the exchange, A is not and has never been a United States shareholder (within the meaning of § 7.367(b)–2(b)) of F. Therefore, A's section 1248 amount with respect to its F stock is zero. Unless § 7.367(b)–4(b)(2)(i) applies, under § 7.367(b)–4(b)(1)(ii) A must include $300 in gross income as gain from the exchange of its F stock.

(e) The facts are the same as in paragraph (a) of this example, except that the F stock does comprise substantially all of A's assets, A transfers all of its stock in F to Y in exchange for 70 percent of Y's outstanding stock, and A remains in existence and does not distribute the Y stock received in the exchange to its shareholders. The exchange of stock of F by A would be described in section 361 (a reorganization described in section 368(a)(1)(C)) if the status of Y as a corporation is recognized. This exchange would also be described in section 354 (a reorganization described in section 368(a)(1) (B)) if the status of F and Y as corporations is recognized. Under § 7.367(b)–4(b), the exchange is considered to be one to which section 367(b) applies. The remaining tax consequences of this exchange are the same as the consequences illustrated in paragraph (a) of this example.

(f) The facts are the same as in paragraph (a) of this example, except that on January 1, 1982, A sells 60 percent of the voting stock of F to a foreign corporation at a gain and reports such gain as required under the Code. At the time of the January 1, 1983 exchange of F stock by A for Y stock, A's adjusted basis in the retained stock of F is $300 and A's section 1248 amount attributable to the retained stock of F is $200. While F is no longer a controlled foreign corporation, A is treated as a United States shareholder of F for five years following the sale of F stock under § 7.367(b)–2(b). Therefore, § 7.367(b)–4(b)(1)(i)(A) and the exception of § 7.367(b)–4(b)(2)(ii) apply to the January 1, 1983 exchange of F stock by A for Y stock, and the tax consequences of that exchange are the same as the consequences illustrated in paragraph (a) of this example.

Example (15). F is a foreign corporation that was organized on January 1, 1979. At all times since this date, A, a domestic corporation, has owned all of the outstanding stock in F. On December 31, 1981, foreign corporation Y acquires all the assets of F in return for voting stock in Y. A exchanges all of its stock in F for the stock in Y and F is liquidated. After the transaction, A is a United States shareholder of Y, and Y is a controlled foreign corporation. Section 354 would apply to the exchange of the stock in F by A, and the transaction would qualify as a reorganization described in section 368(a)(1)(C), if the status of F and Y as corporations is recognized. As of December 31, 1981, F has a deficit in earnings and profits of ($300). A's section 1248 amount with respect to F is also ($300). Assume F had a net operating loss carryover that section 382(b)(2) required to be reduced by 20 percent.

Since A is a United States shareholder of controlled foreign corporation Y, § 7.367(b)–9 applies to the exchange as provided in § 7.367(b)–7(b). Thus, A's section 1248 amount is attributed to the stock in Y received by A. Pursuant to § 7.367(b)–11(c), the amount of the deficit in earnings and profits of F by which the deficit in earnings and profits of Y is increased under § 7.367–9(b)(2) and (c), is reduced by 20 percent from ($300) to ($240). As provided in § 7.367(b)–11 (b) and (d), this deficit and the section 1248 amount attributed to the stock in Y received by A shall be used only in the manner prescribed in section 381(c)(2)(B) and the regulations thereunder.

Example (16). F and G are foreign corporations engaged in the same business activity that were organized on January 1, 1975. At all times since this date, A and B, domestic corporations, have each owned 50 percent of the outstanding stock in F and G, respectively. On January 1, 1980, G acquires all the assets of F in return for G's voting stock. A and B exchange all their stock in F for stock in G, and F is liquidated. After the transaction, G continues the business activity of

F and G unchanged. Section 354 would apply to the exchange of the stock in F by A and B, and the transaction would qualify as a reorganization described in section 368(a)(1)(D), if the status of F and G as foreign corporations is recognized. Under § 7.367(b)–4(d), the transaction is not considered to be a reorganization described in section 368(a)(1)(F) for purposes of section 367 and §§ 7.367(b)–1 through 7.367(b)–12, even though it might be considered to be a reorganization described in section 368(a)(1)(F) for other purposes. Thus, the attribution rules of § 7.367(b)–9 apply by reason of § 7.367(b)–7(b).

Example (17). F and F1 are foreign corporations that were organized on January 1, 1960. X is a domestic corporation that was organized on the same date. At all times since this date, X has owned 100 percent of the outstanding stock in F, and F has owned 100 percent of the outstanding stock in F1. D is a domestic corporation that was organized on January 1, 1976. At all times since this date, X has owned 100 percent of the outstanding stock in D. From January 1, 1960 until January 1, 1974, A, a domestic corporation, owned 100 percent of the outstanding stock in X. On January 1, 1974, B, a domestic corporation, purchased stock in X from A in a taxable sale, and, at all times since this date, A and B each has owned 50 percent of the outstanding stock in X. F, F1, X, D, A, and B each uses the calendar year as its taxable year. As of January 1, 1978, X, F, F1, and D have earnings and profits or deficits as follows:

	X		F		F1		D	
	E&P	Deficit	E&P	Deficit	E&P	Deficit	E&P	Deficit
1960	.....	(200)	.....	(100)	.....	(200)	.....	.....
1961	.....	(200)	.....	(100)	.....	(200)	.....	.....
1962	.....	(200)	.....	(100)	.....	(200)	.....	.....
1963	.....	(200)	100	.....	.....	(200)	.....	.....
1964	.....	(200)	100	.....	.....	(200)	.....	.....
1965	100	.....	100	.....	100	.....	.....	.....
1966	100	.....	100	.....	100	.....	.....	.....
1967	100	.....	100	.....	100	.....	.....	.....
1968	100	.....	100	.....	100	.....	.....	.....
1969	100	.....	100	.....	100	.....	.....	.....
1970	100	.....	100	.....	100	.....	.....	.....
1971	100	.....	100	.....	100	.....	.....	.....
1972	100	.....	100	.....	100	.....	.....	.....
1973	100	.....	100	.....	100	.....	.....	.....
1974	100	.....	100	.....	100	.....	.....	.....
1975	100	.....	100	.....	100	.....	.....	.....
1976	100	.....	100	.....	100	.....	.....	(100)
1977	100	.....	100	.....	100	.....	.....	(100)
Total	1,300	(1,000)	1,500	(300)	1,300	(1,000)	.....	(200)

On January 1, 1978, X distributes all of its stock in F to A in exchange for half of A's stock in X. A's basis in the stock in X that A exchanged is $1,000, and the fair market value of the stock in F that A receives is $2,000. After the distribution, A owns 33 percent and B owns 67 percent of the stock in X.

(a) Section 1248(f) applies to the distribution by X of its stock in F since X is a domestic corporation. See § 7.367(b)–10(b). Thus, X must include the amount computed under section 1248(f)(1) in its gross income as a dividend for 1978. After the distribution, the net fair market value of the assets of the distributing group, X and D, exclusive of the stock in D, equals the net fair market value of the assets of the controlled group, F and F1, exclusive of the stock in F1. Section 355 would apply to the distribution (assuming the conditions of section 355(a)(1) (B) and (C) are met) if the status of F as a corporation is recognized. A and X comply with the reporting requirements of § 7.367(b)–1(c), and X, F, and F1 comply with the recordkeeping requirement of § 7.367(b)–1(d).

The provisions of § 7.367(b)–10(d) through (f) apply to the distribution of the stock in F by reason of § 7.367(b)–10(b). In accordance with § 7.367(b)–10(d), the earnings and profits and deficits of X, F, F1, and D are allocated so that, after the distribution, the distributing group and the controlled group each has total gross earnings and profits of $2,050 ($4,100 total gross earnings and profits of X, F, F1, F1,and D/2), and a total deficit of ($1,250) (($2,500) total gross deficit of X, F, and D/2), as follows:

	E&P	Deficit
Distributing Group:		
X	$2,050	($1,050)
D	.....	(200)
Total	2,050	(1,250)
Controlled Group:		
F	1,098	(288)

	E&P	Deficit
F1	952	(962)
Total	2,050	(1,250)

X's earnings and profits consist of $1,300 actually accumulated by X, $402 allocated from F ($750 allocated from the controlled group X $1,500 earnings and profits of F/$2,800 gross earnings and profits of the controlled group), and $348 allocated from F1 ($750 X $1,300/$2,800). X's deficit consists of ($1,000) acutally incurred by X, ($12) allocated from F (($50) X ($300)/($1,300)), and ($38) allocated from F1 (($50) X ($1,000)/($1,300)). The ($50) deficit allocated to X from F and F1 may be used only as provided in § 7.637(b)–11(b).

A, the only United States shareholder (determined after the distribution) of the controlled group (the group from which in this case the allocation of earnings and profits was made), makes a consent dividend election, described in § 7.367(b)–10(f), in the notice required by § 7.367(b)–1(c). Thus, the $348 of earnings and profits allocated from F1 to X is treated as if, immediately after the distribution of the stock in F, it had been distributed as a dividend to F. (See sections 551 and 951 for possible consequences to A of the consent dividend election.) Since the election under § 7.367(b)–10(f) is made, the basis of F in the stock in F1 is increased by $348 under § 7.367(b)–10(e)(1). In addition, whether or not this election is made, the basis of F in the stock in F1 is decreased under § 7.367(b)–10(e)(1) by the ($38) deficit allocated from F1 to X. Of this decrease, $23 (($38)×($600) pre-1963 gross deficit of F1/($1,000) gross deficit of F) is in respect of pre-1963 deficits and so shall be taken into account, as provided in § 7.367(b)–10(e)(2), only for purposes of computing the all earnings and profits and additional earnings and profits amounts with respect to subsequent transactions.

F is considered to be a corporation and section 355 applies to the distribution by X of the stock in F.

(b) The facts are the same as in example 17(a) except that X is a foreign corporation instead of a domestic corporation. After the distribution by X to A of the stock in F in exchange for half of A's stock in X, the fair market value of the stock in F owned by A equals the fair market value of the stock in X owned by A. Section 355 would apply to the distribution (assuming the conditions of section 355(a)(1) (B) and (C) are met) if the status of F and X as corporations is recognized. A complies with the reporting requirements of § 7.367(b)–1(c), and X, F, and F1 comply with the recordkeeping requirements of § 7.367(b)–1(d).

The application of § 7.367(b)–10 (d) through (f) results in the same allocation of earnings and profits and deficits and adjustments to basis as in example 17(a). In addition, under § 7.367(b)–10 (g), the following amounts are computed with reference to A's and B's stock in X prior to the distribution.

	A	B
Section 1248 amount	$1,650	$600
All earnings and profits amount	150	200
Additional earnings and profits amount	(300)	0

Under § 7.367(b)–10(h), half of each of these amounts of A is attributed to the stock in X and F, respectively, owned by A after the distribution. All of each of these amounts of B is attributed to the stock in X owned by B after the distribution.

X and F are considered to be corporations and section 355 applies to the distribution by X of the stock in F.

(c) The facts are the same as in example (17)(b) except that X distributes its stock in D (rather than its stock in F) to A in exchange for half of A's stock in X. Section 355 would apply to the distribution (assuming the conditions of section 355(a)(1) (B) and (C) are met) if the status of X as a corporation is recognized. A's basis in the stock in X which A exchanges is $1,000 and the fair market value of the stock in D that A receives is $2,000. After the distribution, the net fair market value of the assets of the distributing group, X, F, and F1, exclusive of the stock in F and F1, equals the net fair market value of the assets of the controlled group, D. The value of the stock in D owned by A equals the value of the stock in X owned by A. A complies with the reporting requirements of § 7.367(b)–1(c), and X, F, F1, and D comply with the recordkeeping requirements of § 7.367(b)–1(d).

After the allocation required by § 7.367(b)–10(d), the earnings and profits and deficits of the groups are as follows:

	E & P	Deficit
Distributing Group:		
X	$650	($543.50)
F	750	(163.00)
F1	650	(543.50)
Total	2,050	(1,250.00)
Controlled Group:		
D	2,050	(1,250)

D's earnings and profits consist of $650 allocated from X ($2,050 allocated from distributing group X $1,300 gross earnings and profits of X/$4,100 gross earnings and profits of distributing group), $750 allocated from F ($2,050 X $1,500/$4,100), and $650 allocated from F1 ($2,050 X $1,300/$4,100). D's deficit consists of ($200) actually incurred by D, ($137) allocated from F (($1,050) allocated from Distributing group X ($300) gross deficit of F/($2,300) gross deficit of distributing group), and ($456.50) allocated from X and F1, respectively (($1,050) X ($1,000)/($2,300)).

A and B, the United States shareholders (determined after the distribution) of the distributing group (the group from which in this case the allocation of earnings and profits was made), make a consent dividend election, described in §7.367(b)–10(f), in the notice required by §7.367(b)–1(c). Thus, the $650 of earnings and profits of F1 allocated to D is treated as if, immediately after the distribution of the stock in D, it had been distributed as a dividend through F to X. The $750 of earnings and profits of F allocated to D is treated as if, immediately after the distribution, it had been distributed as a dividend to X. See sections 551 and 951 for possible consequences to A and B of the consent dividend election. Since this election is made, the basis of F in the stock in F1 is increased by $650, and the basis of X in the stock in F is increased by $1,400 ($650 + $750) under §7.367(b)–10(e)(1). In addition, whether or not this election is made, the basis of F in the stock in F1 is decreased by the ($456.50) deficit allocated from F1 to D. Of this decrease, $273.90 (($456.50 X ($600) pre-1963 gross deficit of F1/($1,000) gross deficit of F1) is in respect of a pre-1963 deficit and so shall be taken into account only for purposes of computing the all earnings and profits and additional earnings and profits amounts with respect to subsequent transactions. The basis of X in the stock in F is decreased by $593.50 (($456.50) + ($137) deficit allocated from F to D). Of this decrease, $410.90 (($273.90) + ($137)) is in respect of a pre–1963 deficit and so shall be taken into account only for purposes of computing the all earnings and profits and additional earnings and profits amounts with respect to subsequent transactions.

Under §7.367(b)–10(h), half of A's section 1248 amount of $1,650, all earnings and profits amount of $150, and additional earnings and profits amount of ($300) is attributed to the stock in X owned by A after the distribution of the stock in D. No amounts are attributed to the stock in D owned by A after the distribution. See §7.367–10(i)(1). All of B's section 1248 amount of $600, all earnings and profits amount of $200, and additional earnings and profits amount of $0 is attributed to the stock in X owned by B after the distribution. Section 7.367(b)–10(i) applies since A received stock in D, a domestic corporation. Accordingly, A includes in gross income as a dividend $825 ($1,650 section 1248 amount—$825 attributed to stock in X owned by A after the distribution). This amount increases the earnings and profits of A but does not decrease the earnings and profits of X, F, F1, or D.

X is considered to be a corporation and section 355 applies to the distribution by X of the stock in D.

(Secs. 367(b) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1634 and 68A Stat. 917; 26 U.S.C. 367(b) and 7805))

[44 FR 57390, Oct. 5, 1979, as amended by T.D. 7863, 47 FR 57491, Dec. 27, 1982; 48 FR 1710, Jan. 14, 1983]

§7.367(c)–1 Section 355 distribution treated as an exchange.

(a) *General rule.* For purposes of section 367 as in effect both before and after October 4, 1976, any distribution which is described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is in exchange.

(b) *Ruling required.* In the case of any distribution to which this section applies which begins (within the meaning of §7.367(a)–1(b)(2)) before January 1, 1978, a foreign corporation shall not be considered to be a corporation for purposes of determining the extent to which gain shall be recognized on such distribution unless, pursuant to a ruling request timely filed in accordance with the provisions of §7.367(a)–1(d), it is established to the satisfaction of the Commissioner at the applicable time that such distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(c) *Application of section 367(b) regulations.* In the case of any distribution to which this section applies which begins on or after January 1, 1978, and in connection with which there is no transfer described in section 367(a)(1) (as defined in §7.367(a)–1(b)(3)), the provisions of section 367(b), as amended by the Tax Reform Act of 1976, apply. Accordingly, a foreign corporation shall be considered to be a corporation on such distribution to the extent provided in §§7.367(b)–1 through 7.367(b)–12.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634, 26 U.S.C. 367))

[T.D. 7530, 42 FR 65163, Dec. 30, 1977]

§ 7.367(c)–2 Contribution of capital to controlled corporations.

(a) *General rule.* For purposes of Chapter I of Subtitle A of the Internal Revenue Code of 1954, any transfer of property to a foreign corporation as a contribution to the capital of such corporation which is made after December 31, 1970, by one or more persons who immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote shall, except as provided in paragraph (b) of this section, be treated as an exchange of such property for stock of such foreign corporation equal in value to the fair market value of the property transferred.

(b) *Treatment as contribution to capital.* In the case of a transfer of property referred to in paragraph (a) of this section which begins before October 10, 1975, such transfer shall not be treated as an exchange if, prior to the transfer, it is established that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(c) *Ruling required.* In the case of a transfer of property which begins after October 9, 1975, and which is treated as an exchange under paragraph (a) of this section, a ruling is required if section 367(a)(1) applies. For example, if after October 9, 1975 and before January 1, 1978, a foreign corporation transfers property to its wholly owned foreign subsidiary as a contribution to capital, the exchange which is considered to occur is described in section 351 and section 367(a)(1) applies to such transfer.

(d) *Application of section 367(b) regulations.* In the case of a transfer of property which (i) begins after December 31, 1977, (ii) is treated as an exchange as provided in paragraph (a) of this section, and (iii) is not a transfer described in section 367(a)(1), if such a transfer is an exchange described in section 367(b) or made in connection with an exchange described in that section, a foreign corporation shall be considered to be a corporation on such transfer to the extent and upon fulfillment of any applicable conditions specified in §§ 7.367(b)–1 through 7.367(b)–12.

(Sec. 367 of the Internal Revenue Code of 1954 (90 Stat. 1634; 26 U.S.C. 367))

[T.D. 7530, 42 FR 65163, Dec. 30, 1977]

§ 7.465–1 Amounts at risk with respect to activities begun prior to effective date; in general.

Section 465 provides that a taxpayer (other than a corporation which is not a subchapter S corporation or a personal holding company) engaged in certain activities may not deduct losses from such activity to the extent the losses exceed the amount the taxpayer is at risk with respect to the activity. For the types of activities to which section 465 applies and for determining what constitutes a separate activity, see section 465(c). Section 465 generally applies to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975. For the purposes of applying the at risk limitation to activities begun before the effective date of the provision (and which were not excepted from application of the provision), it is necessary to determine the amount at risk as of the first day of the first taxable year beginning after December 31, 1975. The amount at risk in an activity as of the first day of the first taxable year of the taxpayer beginning after December 31, 1975, (for the purposes of § 7.465–1 through 7.465–5 such first day shall be referred to as the effective date) shall be determined according to the rules provided in §§ 7.465–2 through 7.465–5.

[T.D. 7504, 42 FR 42197, Aug. 22, 1977]

§ 7.465–2 Determination of amount at risk.

(a) *Initial amount.* The amount a taxpayer is at risk on the effective date with respect to an activity to which section 465 applies shall be determined in accordance with this section. The initial amount the taxpayer is at risk in the activity shall be the taxpayer's initial basis in the activity as modified by disregarding amounts described in section 465(b) (3) or (4) (relating generally to amounts protected against loss or borrowed from related persons).

(b) *Succeeding adjustments.* For each taxable year ending before the effective

date, the initial amount at risk shall be increased and decreased by the items which increased and decreased the taxpayer's basis in the activity in that year as modified by disregarding the amounts described in section 465(b) (3) or (4).

(c) *Application of losses and withdrawals.* (1) Losses described in section 465(d) which are incurred in taxable years beginning prior to January 1, 1976 and deducted in such taxable years, will be treated as reducing first that portion of the taxpayer's basis which is attributable to amounts not at risk. On the other hand, withdrawals made in taxable years beginning before January 1, 1976, will be treated as reducing the amount which the taxpayer is at risk.

(2) Therefore, if in a taxable year beginning prior to January 1, 1976 there is a loss described in section 465(d), it shall reduce the amount at risk only to the extent it exceeds the amount of the taxpayer's basis which is not at risk. For the purposes of this paragraph the taxpayer's basis which is not at risk is that portion of the taxpayer's basis in the activity (as of the close of the taxable year and prior to reduction for the loss) which is attributable to amounts described in section 465(b) (3) or (4).

(d) *Amount at risk shall not be less than zero.* If, after determining the amount described in paragraph (a), (b), and (c) of this section, the amount at risk (but for this paragraph) would be less than zero, the amount at risk on the effective date shall be zero.

[T.D. 7504, 42 FR 42197, Aug. 22, 1977]

§ 7.465–3 Allocation of loss for different taxable years.

If the taxable year of the entity conducting the activity differs from that of the taxpayer, the loss attributable to the activity for the first taxable year of the entity ending after the beginning of the first taxable year of the taxpayer beginning after December 31, 1975, shall be allocated in the following manner. That portion of the loss from the activity for such taxable year of the entity which bears the same ratio as the number of days in such taxable year before January 1, 1976, divided by the total number of days in the taxable year, shall be attributable to taxable years of the taxpayer beginning before January 1, 1976. Consequently, that portion shall be treated in accordance with § 7.465–2.

[T.D. 7504, 42 FR 42198, Aug. 22, 1977]

§ 7.465–4 Insufficient records.

If sufficient records do not exist to accurately determine under § 7.465–2 the amount which a taxpayer is at risk on the effective date, the amount at risk shall be the taxpayer's basis in the activity reduced (but not below zero) by the taxpayer's share of amounts described in section 465(b) (3) or (4) with respect to the activity on the day before the effective date.

[T.D. 7504, 42 FR 42198, Aug. 22, 1977]

§ 7.465–5 Examples.

The provisions of § 7.465–1 and § 7.465–2 may be illustrated by the following examples:

Example (1). J and K, as equal partners, form partnership JK on January 1, 1975. Partnership JK is engaged solely in an activity described in section 465(c)(1). On January 1, 1975, each partner contributes $10,000 in cash from personal assets to JK. On July 1, 1975, JK borrows $40,000 (of which J's share is $20,000) from a bank under a nonrecourse financing arrangement secured only by the new equipment (for use in the activity) purchased with the $40,000. On September 1, 1975, JK reduces the amount due on the loan to $36,000 (of which J's share is $18,000). On October 1, 1975, JK distributes $3,000 to each partner. For taxable year 1975, JK has no income or loss. Although J's basis in the activity is $25,000 ($10,000+$18,000—$3,000) J's amount at risk on the effective date is $7,000 determined as follows:

Initial amount at risk	$10,000
Plus: Items which increased basis other than amounts described in sec. 465(b) (3) or (4)	0
Total	10,000
Less: Distribution	3,000
J's amount at risk on effective date	7,000

Example (2). Assume the same facts as in Example (1) except that JK has a loss (as described in section 465(d) for 1975 of which J's share is $12,000. Although J's basis in the activity is $13,000 ($10,000+$18,000—($3,000+$12,000)) J's amount at risk on the effective date is $7,000 determined as follows:

Initial amount at risk	$10,000
Plus: Items which increased basis other than amounts described in sec. 465(b) (3) or (4)	0

Total	10,000
Less: Distribution	3,000
Portion of loss ($12,000) in excess of portion of basis not at risk ($18,000)	0
Total	3,000
J's amount at risk on effective date	7,000

Example (3). Assume the same facts as in Example (1) except that JK has a loss (as described in section 465(d) for 1975, and J's share is $23,000. J's basis in the activity is $2,000 ($10,000+$18,000—($3,000+$23,000)). The amount at risk on the effective date is determined as follows:

Initial amount at risk	$10,000
Plus: Items which increased basis other than amounts described in sec. 465(b) (3) or (4)	0
Total	10,000
Less: Distribution	3,000
Portion of loss ($23,000) in excess of portion of basis not at risk ($18,000)	5,000
Total	8,000
J's amount at risk on the effective date	2,000

[T.D. 7504, 42 FR 42198, Aug. 22, 1977]

§ 7.704–1 Partner's distributive share.

(a)–(c) [Reserved]

(d) *Limitation on allowance of losses.*

(1)–(2) [Reserved]

(3)(i) Section 213(e) of the Tax Reform Act of 1976 amended section 704(d) of the Internal Revenue Code relating to the deductions by partners of losses incurred by a partnership. A partner is entitled to deduct the share of partnership loss to the extent of the adjusted basis of the partner's interest in the partnership. As amended, section 704(d) provides, in general, that the adjusted basis of a partner's interest in the partnership for the purpose of deducting partnership losses shall not include any portion of a partnership liability for which the partner has no personal liability. This restriction, however, does not apply to any activity to the extent that section 465 of the Code applies nor to any partnership whose principal activity is investing in real property, other than mineral property. Section 465 does not apply to corporations other than a subchapter S corporation or a personal holding company.

(ii) The restrictions in the amendment to section 704(d) will not apply to any corporate partner with respect to liabilities incurred in an activity described in section 465(c)(1). In all other respects the restrictions in the amendment will apply to all corporate partners unless the partnership's principal activity is investment in real property, other than mineral property.

[T.D. 7445, 41 FR 55344, Dec. 20, 1976]

§ 7.936–1 Qualified possession source investment income.

For purposes of this section, interest earned after September 30, 1976 (less applicable deductions), by a domestic corporation, engaged in the active conduct of a trade or business in Puerto Rico, which elects the application of section 936 with respect to deposits with certain Puerto Rican financial institutions will be treated as qualified possession source investment income within the meaning of section 936(d)(2) if (1) the interest qualifies for exemption from Puerto Rican income tax under regulations issued by the Secretary of the Treasury of Puerto Rico, as in effect on September 28, 1976, under the authority of section 2(j) of the Puerto Rico Industrial Incentive Act of 1963, as amended, (2) the interest is from sources within Puerto Rico (within the meaning of section 936(d)(2)(A)), and (3) the funds with respect to which the interest is earned are derived from the active conduct of a trade or business in Puerto Rico or from investment of funds so derived.

[T.D. 7452, 41 FR 56794, Dec. 30, 1976]

§ 7.999–1 Computation of the international boycott factor.

(a) *In general.* Sections 908(a), 952(a)(3), and 995(b)(1)(F) provide that certain benefits of the foreign tax credit, deferral of earnings of foreign corporations, and DISC are denied if a person or a member of a controlled group (within the meaning of section 993(a)(3)) that includes that person participates in or cooperates with an international boycott (within the meaning of section 999(b)(3)). The loss of tax benefits may be determined by multiplying the otherwise allowable tax benefits by the ''international boycott factor.'' Section 999(c)(1) provides that the international boycott factor is to be determined under regulations

prescribed by the Secretary. The method of computing the international boycott factor is set forth in paragraph (c) of this section. A special rule for computing the international boycott factor of a person that is a member of two or more controlled groups is set forth in paragraph (d). Transitional rules for making adjustments to the international boycott factor for years affected by the effective dates are set forth in paragraph (e). The definitions of the terms used in this section are set forth in paragraph (b).

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

(1) *Boycotting country.* In respect of a particular international boycott, the term ''boycotting country'' means any country described in section 999(a)(1)(A) or (B) that requires participation in or cooperation with that particular international boycott.

(2) *Participation in or cooperation with an international boycott.* For the definition of the term ''participation in or cooperation with an international boycott'', see section 999(b)(3) and Parts H through M of the Treasury Department's International Boycott Guidelines.

(3) *Operations in or related to a boycotting country.* For the definitions of the terms ''operations'', ''operations in a boycotting country'', ''operations related to a boycotting country'', and ''operations with the government, a company, or a national of a boycotting country'', see Part B of the Treasury Department's International Boycott Guidelines.

(4) *Clearly demonstrating clearly separate and identifiable operations.* For the rules for ''clearly demonstrating clearly separate and identifiable operations'', see Part D of the Treasury Department's International Boycott Guidelines.

(5) *Purchase made from a country.* The terms ''purchase made from a boycotting country'' and ''purchases made from any country other than the United States'' mean, in respect of any particular country, the gross amount paid in connection with the purchase of, the use of, or the right to use:

(i) Tangible personal property (including money) from a stock of goods located in that country,

(ii) Intangible property (other than securities) in that country,

(iii) Securities by a dealer to a beneficial owner that is a resident of that country (but only if the dealer knows or has reason to know the country of residence of the beneficial owner),

(iv) Real property located in that country, or

(v) Services performed in, and the end product of services performed in, that country (other than payroll paid to a person that is an officer or employee of the payor).

(6) *Sales made to a country.* The terms ''sales made to a boycotting country'' and ''sales made to any country other than the United States'' mean, in respect of any particular country, the gross receipts from the sale, exchange, other disposition, or use of:

(i) Tangible personal property (including money) for direct use, consumption, or disposition in that country,

(ii) Services performed in that country,

(iii) The end product of services (wherever performed) for direct use, consumption, or disposition in that country,

(iv) Intangible property (other than securities) in that country,

(v) Securities by a dealer to a beneficial owner that is a resident of that country (but only if the dealer knows or has reason to know the country of residence of the beneficial owner), or

(vi) Real property located in that country.

To determine the country of direct use, consumption, or disposition of tangible personal property and the end product of services, see paragraph (b)(10) of this section.

(7) *Sales made from a country.* The terms ''sales made from a boycotting country'' and ''sales made from any country other than the United States'' mean, in respect of a particular country, the gross receipts from the sale, exchange, other disposition, or use of:

(i) Tangible personal property (including money) from a stock of goods located in that country,

(ii) Intangible property (other than securities) in that country, or

(iii) Services performed in, and the end product of services performed in, that country.

However, gross receipts from any such sale, exchange, other disposition, or use by a person that are included in the numerator of that person's international boycott factor by reason of paragraph (b)(6) of this section shall not again be included in the numerator by reason of this subparagraph.

(8) *Payroll paid or accrued for services performed in a country.* The terms ''payroll paid or accrued for services performed in a boycotting country'' and ''payroll paid or accrued for services performed in any country other than the United States'' mean, in respect of a particular country, the total amount paid or accrued as compensation to officers and employees, including wages, salaries, commissions, and bonuses, for services performed in that country.

(9) *Services performed partly within and partly without a country*—(i) *In general.* Except as provided in paragraph (b)(9)(ii) of this section, for purposes of allocating to a particular country:

(A) The gross amount paid in connection with the purchase or use of,

(B) The gross receipts from the sale, exchange, other disposition or use of, and

(C) The payroll paid or accrued for services performed, or the end product of services performed, partly within and partly without that country, the amount paid, received, or accrued to be allocated to that country, unless the facts and circumstances of a particular case warrant a different amount, will be that amount that bears the same relation to the total amount paid, received, or accrued as the number of days of performance of the services within that country bears to the total number of days of performance of services for which the total amount is paid, received, or accrued.

(ii) *Transportation, telegraph, and cable services.* Transportation, telegraph, and cable services performed partly within one country and partly within another country are allocated between the two countries as follows:

(A) In the case of a purchase of such services performed from Country A to Country B, fifty percent of the gross amount paid is deemed to be a purchase made from Country A and the remaining fifty percent is deemed to be a purchase made from Country B.

(B) In the case of a sale of such services performed from Country A to Country B, fifty percent of the gross receipts is deemed to be a sale made from Country R and the remaining fifty percent is deemed to be a sale made to Country B.

(10) *Country of use, consumption, or disposition.* As a general rule, the country of use, consumption, or disposition of tangible personal property (including money) and the end product of services (wherever performed) is deemed to be the country of destination of the tangible personal property or the end product of the services. (Thus, if legal services are performed in one country and an opinion is given for use by a client in a second country, the end product of the legal services is used, consumed, or disposed of in the second country.) The occurrence in a country of a temporary interruption in the shipment of the tangible personal property or the delivery of the end product of services shall not constitute such country the country of destination. However, if at the time of the transaction the person providing the tangible personal property or the end product of services knew, or should have known from the facts and circumstances surrounding the transaction, that the tangible personal property or the end product of services probably would not be used, consumed, or disposed of in the country of destination, that person must determine the country of ultimate use, consumption or disposition of the tangible personal property or the end product of services. Notwithstanding the preceding provisions of this subparagraph, a person that sells, exchanges, otherwise disposes of, or makes available for use, tangible personal property to any person all of whose business except for an insubstantial part consists of selling from inventory to retail customers at retail outlets all within one country may assume at the time of such sale to such person that the tangible personal property will be used, consumed, or disposed of within such country.

(11) *Controlled group taxable year.* The term ''controlled group taxable year''

means the taxable year of the controlled group's common parent corporation. In the event that no common parent corporation exists, the members of the group shall elect the taxable year of one of the members of the controlled group to serve as the controlled group taxable year. The taxable year election is a binding election to be changed only with the approval of the Secretary of his delegate. The election is to be made in accordance with the procedures set forth in the instructions to Form 5713, the International Boycott Report.

(c) *Computation of international boycott factor*—(1) *In general.* The method of computing the international boycott factor of a person that is not a member of a controlled group is set forth in paragraph (c)(2) of this section. The method of computing the international boycott factor of a person that is a member of a controlled group is set forth in paragraph (c)(3) of this section. For purposes of paragraphs (c) (2) and (3), purchases and sales made by, and payroll paid or accrued by, a partnership are deemed to be made or paid or accrued by a partner in that proportion that the partner's distributive share bears to the purchases and sales made by, and the payroll paid or accrued by, the partnership. Also for purposes of paragraphs (c) (2) and (3), purchases and sales made by, and payroll paid or accrued by, a trust referred to in section 671 are deemed to be made both by the trust (for purposes of determining the trust's international boycott factor), and by a person treated under section 671 as the owner of the trust (but only in that proportion that the portion of the trust that such person is considered as owning under sections 671 through 679 bears to the purchases and sales made by, and the payroll paid and accrued by, the trust).

(2) *International boycott factor of a person that is not a member of a controlled group.* The international boycott factor to be applied by a person that is not a member of a controlled group (within the meaning of section 993(a)(3)) is a fraction.

(i) The numerator of the fraction is the sum of the—

(A) Purchases made from all boycotting countries associated in carrying out a particular international boycott.

(B) Sales made to or from all boycotting countries associated in carrying out a particular international boycott, and

(C) Payroll paid or accrued for services performed in all boycotting countries associated in carrying out a particular international boycott by that person during that person's taxable year, minus the amount of such purchases, sales, and payroll that is clearly demonstrated to be attributable to clearly separate and identifiable operations in connection with which there was no participation in or cooperation with that international boycott.

(ii) The denominator of the fraction is the sum of the—

(A) Purchases made from any country other than the United States,

(B) Sales made to or from any country other than the United States, and

(C) Payroll paid or accrued for services performed in any country other than the United States by that person during that person's taxable year.

(3) *International boycott factor of a person that is a member of a controlled group.* The international boycott factor to be applied by a person that is a member of a controlled group (within the meaning of section 993(a)(3)) shall be computed in the manner described in paragraph (c)(2) of this section, except that there shall be taken into account the purchases and sales made by, and the payroll paid or accrued by, each member of the controlled group during each member's own taxable year that ends with or within the controlled group taxable year that ends with or within that person's taxable year.

(d) *Computation of the international boycott factor of a person that is a member of two or more controlled groups.* The international boycott factor to be applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) by a person that is a member of two or more controlled groups shall be determined in the manner described in paragraph (c)(3), except that the purchases, sales, and payroll included in the number and denominator shall include the purchases, sales, and payroll of that person and of all other members of the two or more

controlled groups of which that person is a member.

(e) *Transitional rules*—(1) *Pre-November 3, 1976 boycotting operations.* The international boycott factor to be applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) by a person that is not a member of a controlled group, for that person's taxable year that includes November 3, 1976, or a person that is a member of a controlled group, for the controlled group taxable year that includes November 3, 1976, shall be computed in the manner described in paragraphs (c)(2) and (c)(3), respectively, of this section. However, that the following adjustments shall be made:

(i) There shall be excluded from the numerators described in paragraphs (c)(2)(i) and (c)(3)(i) of this section purchases, sales, and payroll clearly demonstrated to be attributable to clearly separate and identifiable operations—

(A) That were completed on or before November 3, 1976, or

(B) In respect of which it is demonstrated that the agreements constituting participation in or cooperation with the international boycott were renounced, the renunciations were communicated on or before November 3, 1976, to the governments or persons with which the agreements were made and the agreements have not been reaffirmed after November 3, 1976, and

(ii) The international boycott factor resulting after the numerator has been modified in accordance with paragraph (e)(1)(i) of this section shall be further modified by multiplying it by a fraction. The numerator of that fraction shall be the number of days in that person's taxable year (or, if applicable, in that person's controlled group taxable year) remaining after November 3, 1976, and the denominator shall be 366.

The principles of this subparagraph are illustrated in the following example:

Example. Corporation A, a calendar year taxpayer, is not a member of a controlled group. During the 1976 calendar year, Corporation DA had three operations in a boycotting country under three separate contracts, each of which contained agreements constituting participation in or cooperation with an international boycott. Each contract was entered into on or after September 2, 1976. Operation (1) was completed on November 1, 1976. The sales made to a boycotting country in connection with Operation (1) amounted to $10. Operation (2) was not completed during the taxable year, but on November 1, 1976, Corporation A communicated a renunciation of the boycott agreement covering that operation to the government of the boycotting country. The sales made to a boycotting country in connection with Operation (2) amounted to $40. Operation (3) was not completed during the taxable year, nor was any renunciation of the boycott agreement made. The sales made to a boycotting country in connection with Operation (3) amounted to $25. Corporation A had no purchases made from, sales made from, or payroll paid or accrued for services performed in, a boycotting country. Corporation A had $500 of purchases made from, sales made from, sales made to, and payroll paid or accrued for services performed in, countries other than the United States. Company A's boycott factor for 1976, computed under paragraph (c)(2) of this section (before the application of this subparagraph) would be:

$$(\$10 + \$40 + \$25) / \$500 = (\$75 / \$500)$$

However, the $10 is eliminated from the numerator by reason of paragraph (e)(1)(i)(A) of this section, and the $40 is eliminated from the numerator by reason of paragraph (e)(1)(i)(B) of this section. Thus, before the application of paragraph (e)(1)(ii) of this section, Corporation A's international boycott factor is $25/$500. After the application of paragraph (e)(1)(ii), Corporation A's international boycott factor is:

$$(\$25 / \$500) \times (58 / 366)$$

(2) *Pre-December 31, 1977 boycotting operations.* The international boycott factor to be applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) by a person that is not a member of a controlled group, for that person's taxable year that includes December 31, 1977, or by a person that is a member of a controlled group, for the controlled group taxable year that includes December 31, 1977, shall be computed in the manner described in paragraphs (c)(2) and (c)(3), respectively, of this section. However, the following adjustments shall be made:

(i) There shall be excluded from the numerators described in paragraphs (c)(2)(i) and (c)(3)(i) of this section purchases, sales, and payroll clearly demonstrated to be attributable to clearly separate and identifiable operations that were carried out in accordance

with the terms of binding contracts entered into before September 2, 1976, and—

(A) That were completed on or before December 31, 1977, or

(B) In respect of which it is demonstrated that the agreements constituting participation in or cooperation with the international boycott were renounced, the renunciations were communicated on or before December 31, 1977, to the governments or persons with which the agreements were made, and the agreements were not reaffirmed after December 31, 1977, and

(ii) In the case of clearly separate and identifiable operations that are carried out in accordance with the terms of binding contracts entered into before September 2, 1976, but that do not meet the requirements of paragraph (e)(2)(i) of this section, the numerators described in paragraphs (c)(2)(i) and (c)(3)(i) of this section shall be adjusted by multiplying the purchases, sales, and payroll clearly demonstrated to be attributable to those operations by a fraction, the numerator of which is the number of days in such person's taxable year (or, if applicable, in such person's controlled group taxable year) remaining after December 31, 1977, and the denominator of which is 365.

The principles of this subparagraph are illustrated in the following example:

Example. Corporation A is not a member of a controlled group and reports on the basis of a July 1–June 30 fiscal year. During the 1977–1978 fiscal year, Corporation A had 2 operations carried out pursuant to the terms of separate contracts, each of which had a clause that constituted participation in or cooperation with an international boycott. Neither operation was completed during the fiscal year, nor were either of the boycotting clauses renounced. Operation (1) was carried out in accordance with the terms of a contract entered into on November 15, 1976. Operation (2) was carried out in accordance with the terms of a binding contract entered into before September 2, 1976. Corporation A had sales made to a boycotting country in connection with Operation (1) in the amount of $50, and in connection with Operation (2) in the amount of $100. Corporation A had sales made to countries other than the United States in the amount of $500. Corporation A had no purchases made from, sales made from, or payroll paid or accrued for services performed in, any country other than the United States. In the absence of this subparagraph, Corporation A's international boycott factor would be

$$(\$50 + \$100) / \$500.$$

However, by reason of the application of this subparagraph, Corporation A's international boycott factor is reduced to

$$\left[(\$50 + \$100)(181 / 365)\right] / \$500$$

(3) *Incomplete controlled group taxable year.* If, at the end of the taxable year of a person that is a member of a controlled group, the controlled group taxable year that includes November 3, 1976 has not ended, or the taxable year of one or more members of the controlled group that includes November 3, 1976 has not ended, then the international boycott factor to be applied under sections 908(a), 952(a)(3) and 995(b)(1)(F) by such person for the taxable year shall be computed in the manner described in paragraph (c)(3) of this section. However, the numerator and the denominator in that paragraph shall include only the purchases, sales, and payroll of those members of the controlled group whose taxable years ending after November 3, 1976 have ended as the end of the taxable year of such person.

(f) *Effective date.* This section applies to participation in or cooperation with

an international boycott after November 3, 1976. In the case of operations which constitute participation in or cooperation with an international boycott and which are carried out in accordance with the terms of a binding contract entered into before September 2, 1976, this section applies to such participation or cooperation after December 31, 1977.

[T.D. 7467, 42 FR 11833, Mar. 1, 1977]

§ 7.6039A–1 Information regarding carryover basis property acquired from a decedent.

(a) *Information for Internal Revenue Service.* In the case of a decedent who dies after December 31, 1976, the executor (as defined in section 2203) shall furnish to the Internal Revenue Service the following information, as applicable—

(1) If an estate tax return is required to be filed under section 6018 of the Internal Revenue Code of 1954, as amended, and if the return form contains questions relating to carryover basis property, the executor must answer those questions.

(2) If no estate tax return is required to be filed under section 6018 of the Internal Revenue Code of 1954, as amended, or if a return is required to be filed but the return form used does not contain questions relating to carryover basis property, the executor must file the form prescribed by the Commissioner. This form may be attached to the estate tax return or the decedent's final individual income tax return. If this form is not attached to the estate tax return or the decedent's final individual income tax return, it must be filed with the Internal Revenue Service office where the decedent's final income tax return would be filed if one were required within 9 months after the date of the decedent's death or by December 31, 1978, whichever is later.

(b) *Information to be furnished to beneficiaries.* Any executor required under paragraph (a) of this section to furnish information to the Internal Revenue Service relating to carryover basis property must furnish in writing to the distributee of each piece of carryover basis property—

(1) A description of the property,

(2) The adjusted basis of the property as computed under section 1023 (a), (c), and (d),

(3) The amount of the increase in the basis of the property determined under section 1023(h),

(4) The value of the property for Federal estate tax purposes, and

(5) A notice that the beneficiary should keep this information as part of permanent records.

(c) *Time for furnishing information to beneficiaries.* The information which an executor is required to furnish to the beneficiaries under this paragraph must be furnished on or before the latest of—

(1) The date the property is distributed to the beneficiary,

(2)(i) In the case of an executor who is required to file an estate tax return, 6 months after the due date (including extensions) of such return,

(ii) In the case of an executor who is not required to file an estate tax return, 15 months from the date of death of the decedent, or

(3) December 31, 1978.

(d) *Subsequent adjustments to carryover basis.* In the event subsequent adjustments are made which relate to the carryover basis of any piece of property included in a decedent's gross estate, whether by reason of an adjustment resulting from an examination of the estate tax return or otherwise, any executor required under paragraph (a) of this section to furnish information to the Internal Revenue Service shall, within 3 months of a determination, as defined in section 1313 (a), of such adjustments, provide to the recipient of each item of carryover basis property the information set forth in paragraph (b) of this section recomputed as required by such adjustments.

(e) *Effective date.* This section is effective in respect of decedents dying after December 31, 1976.

(Secs. 7805 and 6039A of the Internal Revenue Code of 1954 (68A Stat. 917, 90 Stat. 1878; 26 U.S.C. 7805, 6039A))

[T.D. 7540, 43 FR 16735, Apr. 20, 1978, as amended by T.D. 7559, 43 FR 36244, Aug. 16, 1978]

§7.6041–1 Return of information as to payments of winnings from bingo, keno, and slot machines.

(a) *In general.* On or after May 1, 1977, every person engaged in a trade or business and making a payment in the course of such trade or business of winnings (including winnings which are exempt from withholding under section 3402(q)(5)) of $1,200 or more from a bingo game or slot machine play or of $1,500 or more from a keno game shall make an information return with respect to such payment.

(b) *Special rules.* For purposes of paragraph (a) of this section, in determining whether such winnings equal or exceed the $1,200 or $1,500 amount—

(1) In the case of a bingo game or slot machine play, the amount of winnings shall not be reduced by the amount wagered;

(2) In the case of a keno game, the amount of winnings from one game shall be reduced by the amount wagered in that one game;

(3) Winnings shall include the fair market value of a payment in any medium other than cash;

(4) All winnings by the winner from one bingo or keno game shall be aggregated; and

(5) Winnings and losses from any other wagering transaction by the winner shall not be taken into account.

(c) *Prescribed form.* The return required by paragraph (a) of this section shall be made on Form W–2G and shall be filed with the Internal Revenue Service Center serving the district in which is located the principal place of business of the person making the return on or before February 28 of the calendar year following the calendar year in which the payment of winnings is made. Each Form W–2G shall contain the following:

(1) Name, address, and employer identification number of the person making the payment;

(2) Name, address, and social security number of the winner;

(3) General description of two types of identification *(e.g.,* ''driver's license'', ''social security card'', or ''voter registration card'') furnished to the maker of the payment for verification of the winner's name, address, and social security number;

(4) Date and amount of the payment; and

(5) Type of wagering transaction.

In addition, in the case of a bingo or keno game, Form W–2G shall show any number, color, or other designation assigned to the game with respect to which the payment is made. In the case of a slot machine play, Form W–2G shall show the identification number of the slot machine.

[T.D. 7457, 42 FR 1471, Jan. 7, 1977, as amended by T.D. 7492, 42 FR 33286, June 30, 1977]

PART 8—TEMPORARY INCOME TAX REGULATIONS UNDER SECTION 3 OF THE ACT OF OCTOBER 26, 1974 (PUB. L. 93–483)

AUTHORITY: Secs. 2055(e)(3) and 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

§8.1 Charitable remainder trusts.

(a) *Certain wills and trusts in existence on September 21, 1974.* In the case of a will executed before September 21, 1974, or a trust created (within the meaning of applicable local law) after July 31, 1969, and before September 21, 1974, which is amended pursuant to section 2055(e)(3) and §24.1 of this chapter (Temporary Estate Tax Regulations), a charitable remainder trust resulting from such amendment will be treated as a charitable remainder trust from the date it would be deemed created under §1.664–1(a) (4) and (5) of this chapter (Income Tax Regulations), whether or not such date is after September 20, 1974.

(b) *Certain transfers to trusts created before August 1, 1969.* Property transferred to a trust created (within the meaning of applicable local law) before August 1, 1969, whose governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust shall be deemed transferred to a trust created on the date of such transfer, provided that the transfer occurs after July 31, 1969 and prior to October 18, 1971, and pursuant to an amendment provided in §24.1 of this chapter (Temporary Estate Tax Regulations), the transferred property and any undistributed income therefrom is severed and

placed in a separate trust as of the date of the amendment.

[T.D. 7393, 40 FR 58853, Dec. 19, 1975]

PART 9—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REDUCTION ACT OF 1975

Sec.

9.1 Investment credit—public utility property elections.
9.2 [Reserved]
9.3 Temporary TRASOP requirements for 1-percent additional investment credit.

§ 9.1 Investment credit—public utility property elections.

(a) *Applicability of prior election under section 46(f)*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an election made before March 10, 1972 (hereinafter referred to as a 1972 election) under section 46(f) (redesignated from section 46(e) by the Tax Reduction Act of 1975) applies to the credit allowable for a taxable year with respect to public utility property described in section 46(f)(5) by reason of sections 301 and 302 of the Tax Reduction Act of 1975.

(2) *1972 immediate flow-through election.* A 1972 election under section 46(f)(3) (hereinafter referred to as an election for immediate flow-through) does not apply to the additional credit allowed under section 38 with respect to limited property (public utility property described in section 46(c)(3)(B) to which section 167(1)(2)(C) applies, other than nonregulated communication property of the type described in the last sentence of section 46(c)(3)(B) by reason of the Tax Reduction Act of 1975. However, a 1972 election for immediate flow-through does apply to the additional credit allowed for a taxable year with respect to property described in section 46(f)(5)(B). See paragraph (b) of this section for a new election under section 46(f)(3) with regard to the additional credit with respect to limited property allowed by reason of the Tax Reduction Act of 1975. See paragraph (a)(3) of this section for determination of additional credit. For purposes of this section the phrase ''determined as if the Tax Reduction Act had not been enacted'' means the following amendments shall be disregarded in determining credit allowable or allowed:

(i) The increase in the amount of credit from 7 percent to 10 or 11 percent under section 46(a)(1) (A), (B), and (D),

(ii) The increase in the amount of qualified investment from 4/7 to 7/7 under section 46(a)(1)(C) and (c)(3)(A),

(iii) The increase in the dollar limitation from $50,000 to $100,000 on used property under section 48(c)(2), and

(iv) The increase in the limitation based on tax under section 46(a)(6) for certain public utilities.

In determining the amount of credit attributable to limited property possible disallowance under section 46(f) shall be disregarded.

(3) *Additional credit allowed*—(i) *Credit earned in taxable year.* The amount of additional credit allowed for credit earned for limited property for taxable year is an amount equal to the excess of—

(A) The credit allowed by section 38 for the taxable year (determined without regard to section 46(b)) multiplied by a fraction, the numerator of which is the amount of credit earned for limited property for the taxable year and the denominator of which is the amount of credit earned for all section 38 property for the taxable year, over

(B) The amount of normal credit allowed for limited property for the taxable year (determined without regard to section 46(b)). The amount of normal credit allowed for limited property is the amount of credit that would be allowed for the taxable year determined as if the Tax Reduction Act had not been enacted multiplied by a fraction, the numerator of which is the amount of credit earned for limited property for the taxable year determined as if the Tax Reduction Act had not been enacted and the denominator of which is the credit earned for all section 38 property for the taxable year determined as if the Tax Reduction Act had not been enacted.

(ii) *Carryover or carryback to taxable year.* The amount of additional credit allowed for limited property attributable to a carryover or a carryback of any unused credit to any taxable year in an amount equal to the excess of—

(A) The amount of credit allowed by section 38 for the taxable year by reason of section 46(b) multiplied by the fraction contained in paragraph (a)(3)(i)(A) of this section for the unused credit year, over

(B) The amount of unused normal credit allowed for limited property for the taxable year. The amount of unused normal credit allowed for limited property is the amount of unused credit that would be allowed for the taxable year under section 38 by reason of section 46(b), taking into account the amount of unused credit that would be allowed for any preceding year, determined as if the Tax Reduction Act had not been enacted, multiplied by the fraction contained in paragraph (a)(3)(i)(B) of this section for the unused credit year.

(b) *New election*—(1) *In general.* A taxpayer who made a 1972 election for immedite flow-through under section 46(f)(3) with respect to limited property may elect to apply section 46(f)(3) to the additional credit allowed by the Tax Reduction Act of 1975 with respect to such property, or, if eligible, may make the election in paragraph (b)(2) of this section to apply section 46(f)(2) to such additional credit. The election to apply section 46(f) (2) or (3) must be made before June 28, 1975, in the manner provided in paragraph (c) of this section. If the taxpayer does not make a new election, section 46(f)(1) shall apply to additional credit for limited property. However, if the taxpayer made a 1972 election under section 46(f)(2) with respect to property to which section 46(f)(3) does not apply, then section 46(f)(2) shall apply to such additional credit notwithstanding any prohibition in section 46(f)(3) to the contrary.

(2) *Special section 46(f)(2) election.* A taxpayer who:

(i) Made a 1972 election under section 46(f)(3),

(ii) Did not make an election to apply section 46(f)(2) with respect to property to which section 46(f)(3) does not apply, and

(iii) Did not acquire property to which section 46(f)(1) applied in any taxable year ending before January 1, 1975, may elect to apply section 46(f)(2) to the additional credit allowed by the Tax Reduction Act of 1975 with respect to limited property notwithstanding any prohibition in section 46(f)(3) to the contrary.

(c) *Method of making election.* A taxpayer may make an election described in paragraph (b) of this section by filing a statement before June 28, 1975, with the district director or director of the internal revenue service center with whom the taxpayer ordinarily files its income tax return. For rules with respect to taxpayers filing consolidated returns, see §1.1502–77(a) of part 1 of this chapter. The statement shall contain the following information: (1) The name, address, and taxpayer identification number of the taxpayer, and (2) the election which the taxpayer is making under paragraph (b) of this section. If a taxpayer is electing flow-through under section 46(f)(3), the statement shall also contain a written recitation that the election is made at the taxpayer's own option and without regard to any requirement imposed by an agency described in section 46(c)(3)(B) having jurisdiction over the taxpayer. The recitation shall be verified by a written declaration that it is made under the penalties of perjury.

(Secs. 46(f) and 7805 of the Internal Revenue Code of 1954 (85 Stat. 503, 68A Stat. 917; 26 U.S.C. 46, 7805))

[T.D. 7360, 40 FR 25472, June 16, 1975]

§9.2 [Reserved]

§9.3 Temporary TRASOP requirements for 1-percent additional investment credit.

The provisions listed in §1.46–8 (a)(4)(i)—(ix) (Income Tax Regulations) are deemed effective only as temporary regulations under this section.

(Sec. 301(d)(2)(C) and (10) of the Tax Reduction Act of 1975 and sec. 7805 of the Internal Revenue Code of 1954 (89 Stat. 38, 68A Stat. 917 (26 U.S.C. 7805)))

[T.D. 7589, 44 FR 4145, Jan. 16, 1979; 44 FR 6715, Feb. 2, 1979]

PART 11—TEMPORARY INCOME TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Sec.

11.401(a)–11 Qualified joint and survivor annuities.

11.401(a)–19 Nonforfeitability in case of certain withdrawals.
11.401(b)–1 Certain retroactive changes in plan.
11.401(d)(1)–1 Nonbank trustees of trusts benefiting owner-employees.
11.402(e)(4)(A)–1 Lump sum distributions in the case of an employee who has separated from service.
11.402(e)(4)(B)–1 Election to treat an amount as a lump sum distribution.
11.404(a)(6)–1 Time when contributions to ''H.R. 10'' plans considered made.
11.408(a)(2)–1 Trustee of individual retirement accounts.
11.410–1 Election by church to have participation, vesting, funding, etc., provisions apply.
11.410(b)–1 Minimum coverage requirements.
11.412(c)–7 Election to treat certain retroactive plan amendments as made on the first day of the plan year.
11.412(c)–11 Election with respect to bonds.
11.412(c)–12 Extension of time to make contributions to satisfy requirements of section 412.
11.415(c)(4)–1 Special elections for section 403(b) annuity contracts purchased by educational institutions, hospitals and home health service agencies.

AUTHORITY: Sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805), unless otherwise noted.

§ 11.401(a)–11 Qualified joint and survivor annuities.

(a) *In general*—(1) *General rule.* A trust, which is a part of a plan providing for the payment of benefits in any form of a life annuity (*i.e.*, an annuity requiring survival of the participant or his spouse as a condition for payment), shall not constitute a qualified trust under section 401(a)(11) and this section unless such plan provides that these benefits must be paid in a form having the effect of a qualified joint and survivor annuity. Therefore, any benefits which may be paid in any form of a life annuity must be paid in a form having the effect of a qualified joint and survivor annuity unless the participant makes the election, described in paragraph (c) of this section, not to receive benefits in this form. A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it provides that the spouse of a deceased participant may elect to have benefits paid in a form other than a qualified joint and survivor annuity. Section 401(a)(11) and this section shall apply only in the case of a plan to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2). Without regard to the election provided under paragraph (d)(3) of this section, unless an election has been made under paragraph (c) of this section, a plan to which this section applies must provide that a survivor annuity shall be payable on the death of an active participant after normal retirement age.

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

Example. The X Corporation Defined Contribution Plan was established in 1960. As in effect on January 1, 1974, the plan provided that, upon his retirement, a participant could elect to receive the balance of his individual account in the form of (1) a lump-sum cash payment, (2) a lump-sum distribution consisting of X Corporation stock, (3) five equal annual cash payments, (4) a life annuity, or (5) a combination of options (1) through (4). The plan also provided that, if a participant did not elect another form of distribution, the balance of his individual account would be distributed to him in the form of a lump-sum cash payment upon his retirement. Assume that section 401(a)(11) and this section first become applicable to the plan as of its plan year beginning January 1, 1976, with respect to persons who were active participants in the plan on such date (see paragraph (h) of this section). Unless the X Corporation Defined Contribution Plan either discontinues the life annuity payment option or is amended to provide that the balance of a participant's individual account will be paid to him in a form having the effect of a qualified joint and survivor annuity unless the participant elects another form of benefit payment, the trust established under the plan will fail to qualify under section 401(a).

(b) *Definitions.* As used in this section—

(1) *Qualified joint and survivor annuity.* The term ''qualified joint and survivor annuity'' means an annuity for the life of the participant with a survivor annuity for the life of his spouse which is neither (i) less than one-half of, nor (ii) greater than, the amount of the annuity payable during the joint lives of the participant and his spouse. A qualified joint and survivor annuity must be at least the actuarial equivalent of the normal form of annuity or

any optional form of benefit offered under the plan. Equivalence may be determined, on the basis of consistently applied reasonable actuarial factors, for each participant or for all participants or reasonable groupings of participants, if such determination does not result in discrimination in favor of employees who are officers, shareholders, or highly compensated. An annuity is not a qualified joint and survivor annuity if payments to the spouse of a deceased participant are terminated because of such spouse's remarriage.

(2) *Annuity starting date.* The term ''annuity starting date'' means the first day of the first period with respect to which an amount is received as an annuity, whether by reason of retirement or by reason of disability.

(3) *Earliest retirement age.* The term ''earliest retirement age'' means the earliest date on which, under the plan, the participant could elect to receive retirement benefits, including any benefit the participant is entitled to receive on account of disability.

(c) *Election not to take joint and survivor annuity form*—(1) *In general.* A plan shall not be treated as satisfying the requirements of this section unless each participant has the right to elect in writing not to take a joint and survivor annuity during a reasonable period before the annuity starting date. However, if a plan provides that a qualified joint and survivor annuity is the only form of benefit payable under the plan, no election need be provided.

(2) *Information to be provided to the participant.* (i) The plan administrator must furnish to the participant a written notification, in nontechnical terms, of the availability of the election provided by this paragraph, within a reasonable amount of time after the first day of the election period. This notification shall also inform the participant of the availability of the information specified in subdivision (ii) of this subparagraph.

(ii) The plan administrator must furnish to the participant a written explanation in nontechnical language of the terms and conditions of the joint and survivor annuity and the financial effect upon the participant's annuity (in terms of dollars per annuity payment) of making an election under this paragraph. This explanation must be provided to the participant within a reasonable amount of time from the date of the participant's request during the election period.

(3) *Form of election.* The election shall be in writing and clearly indicate that the participant is electing to receive his benefits under the plan in a form other than that of a joint and survivor annuity.

(4) *Election is revocable.* This election may be revoked in writing during the election period. After an election is revoked another election under this paragraph may be made during the election period.

(d) *Plans providing for early retirement*—(1) *Period during which qualified joint and survivor annuity not required.* Notwithstanding the provisions of paragraph (a) of this section, in the case of a plan which provides for the payment of benefits before the normal retirement age (as defined in section 411(a)(8)), the plan is not required to provide for the payment of annuity benefits in a form having the effect of a qualified joint and survivor annuity during the period beginning on the date on which the employee enters into the plan as a participant and ending on the later of—

(i) The date the employee reaches the earliest retirement age under the plan (as defined in paragraph (b)(3) of this section), or

(ii) The first day of the 120th month beginning before the date on which the employee reaches normal retirement age.

(2) *Period during which qualified joint and survivor annuity required.* (i) If a participant terminates employment and begins to receive retirement benefits during the period described in subparagraph (1) of this paragraph, he and his spouse must receive, after the termination of such period (or after the date such period would have terminated if the participant had survived), benefits having the effect of a qualified joint and survivor annuity, unless the participant has made an election under paragraph (c) of this section.

(ii) If a participant terminates employment and begins to receive retirement benefits after the period described in subparagraph (1) of this

paragraph, he and his spouse must receive benefits having the effect of a qualified joint and survivor annuity, unless the participant has made an election under paragraph (c) of this section.

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

Example. A plan which provides a benefit in the form of a life annuity also provides that a participant may retire before the normal retirement age of 65 and receive a benefit, if he has completed 30 years of service. A, an employee, became a participant at the age of 18. A retires and begins to receive retirement benefits at the age of 48. Unless A otherwise elects, the plan must provide a qualified joint and survivor annuity to A and his spouse after A reaches age 55 (the later of the earliest retirement age (age 48) or 10 years before normal retirement age (age 55)) or after the date A would have reached age 55, if he had survived. The survivor annuity paid to the spouse must satisfy the requirements of paragraph (b)(1) of this section. The plan may, but is not required to, provide the survivor annuity before age 55 if the participant dies between age 48 and age 55.

(3) *Election of survivor annuity*—(i) *In general.* (A) A plan described in subparagraph (1) of this paragraph does not meet the requirements of paragraph (a) of this section unless, under the plan, a participant may elect, during a reasonable period, a survivor annuity to be payable on his death during the period beginning on the date on which the period described in subparagraph (1) of this paragraph ends and ending on the date on which he reaches normal retirement age if he continues his employment during that period. Breaks in service during that period will neither invalidate a previous election or revocation nor prevent an election from being made or revoked during the election period.

(B) If a plan provides that a survivor annuity is the only form of benefit payable under the plan, no election need be provided.

(ii) *Example.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A plan which provides a life annuity also provides that a participant may retire before the normal retirement age of 65 and receive a benefit, if he has completed 30 years of service. Under this plan, an employee who became a participant at the age of 18 will be eligible to receive retirement benefits at the age of 48. This plan must allow a participant who continues his employment to elect a survivor annuity, described in subdivision (v) of this subparagraph, to be payable on the death of the participant if death occurs after age 55 (the later of the date the participant reaches the earliest retirement age (age 48) or 10 years before normal retirement age (age 55)) but before the date the participant reaches normal retirement age (age 65).

(iii) *Information to be provided by plan administrator.* (A) The plan administrator must furnish to the participant a written notification in nontechnical terms of the availability of the election provided by this subparagraph, within a reasonable amount of time after the first day of the election period. This notification shall also inform the participant of the availability of the information specified in subdivision (iii)(B) of this subparagraph.

(B) During the election period, the plan administrator must furnish to the participant, within a reasonable amount of time from the date of his request, a written explanation in nontechnical language of the terms and conditions of the survivor annuity and the financial effect upon the participant's annuity (in terms of dollars per annuity payment) of an election or of a revocation of an election under this subparagraph.

(iv) *Payments under the survivor annuity.* In order to meet the requirements of this subparagraph, if an election is made, the payments under the survivor annuity must not be less than the payments which would have been made under the joint and survivor annuity to which the surviving spouse would have been entitled if the participant had made the election described in this subparagraph immediately prior to his retirement and if his retirement had occurred on the day before his death and within the period during which an election can be made. For example, if a participant is entitled to a single life annuity of $100 per month or a reduced amount under a qualified joint and survivor annuity of $80 per month, regardless of when he makes a valid election

under subparagraph (2) of this paragraph, his spouse is entitled to a payment of at least $40, but not more than $80 per month, under the survivor annuity.

(v) *Form of election.* The election shall be in writing and clearly indicate that the participant is electing the joint and survivor annuity form.

(vi) *Election is revocable.* An election under this subparagraph may be revoked in writing during the election period. After an election has been revoked, another election under this subparagraph may be made during the election period. See paragraph (c) of this section, relating to the right to elect not to take the joint and survivor annuity form.

(e) *Marriage requirements.* (1) A plan shall be treated as satisfying the requirements of this section even though it requires the participant and his spouse to have been married to each other on the annuity starting date.

(2) A plan shall be treated as satisfying the requirements of this section even though it provides that the spouse of the participant is not entitled to receive a survivor annuity (whether or not the election described in paragraph (d)(3) of this section has been made) unless the participant and his spouse have been married to each other throughout the 1-year period ending on the date of such participant's death.

(f) *Effect of participant's death on an election or revocation of an election under paragraph (c)* or *(d)(3).* A plan shall not be treated as not satisfying the requirements of this section merely because the plan contains a provision that any election made under paragraph (c) or (d)(3) of this section and any revocation of any such election does not become effective or ceases to be effective if the participant dies within a period, not in excess of 2 years, beginning on the date of such election or revocation. A plan containing a provision described in the preceding sentence shall not satisfy the requirements of this section unless it also provides that any such election and any revocation of any such election will be given effect in any case in which—

(1) The participant dies from accidental causes,

(2) A failure to give effect to the election or revocation would deprive the participant's survivor of a survivor annuity, and

(3) Such election or revocation is made before such accident occurred.

(g) *Costs of providing joint and survivor annuity form.* A plan may take into account in any equitable manner consistent with generally accepted actuarial principles applied on a consistent basis any increased costs resulting from providing joint and survivor annuity benefits.

(h) *Application and effective date.* (1) Section 401(a)(11) and this section shall apply to a plan only with respect to plan years to which section 411 (relating to minimum vesting standards) is applicable to the plan.

(2) Section 401(a)(11) and this section shall apply if—

(i) The participant's annuity starting date falls within a plan year beginning after December 31, 1975, and

(ii) The participant was an active participant in the plan on or after the first day of the first plan year beginning after December 31, 1975.

For purposes of this paragraph, the term ''active participant'' means a participant for whom benefits are being accrued under the plan on his behalf, the employer is obligated to contribute to or under the plan on his behalf, or the employer would have been obligated to contribute to or under the plan on his behalf if any contributions were made to or under the plan.

(Sec. 401(a)(11) of the Internal Revenue Code of 1954, 88 Stat. 935 (26 U.S.C. 401(a)(11)))

[T.D. 7379, 40 FR 45810, Oct. 3, 1975; 40 FR 49326, Oct. 22, 1975]

§11.401(a)–19 Nonforfeitability in case of certain withdrawals.

(a) *Application of section.* Section 401(a)(19) and this section apply to a plan to which section 411(a) applies. (See section 411(e) and §11.411(a)–2 for applicability of section 411.)

(b) *Prohibited forfeitures*—(1) *General rule.* A plan to which this section applies is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if, under such plan, any part of a participant's accrued benefit derived from employer contributions is

forfeitable solely because a benefit derived from the participant's contributions under the plan is voluntarily withdrawn by him after he has become a 50 percent vested participant.

(2) *50 percent vested participant.* For purposes of paragraph (b)(1) of this section, a participant is a 50 percent vested participant when he has a nonforfeitable right (within the meaning of section 411 and the regulations thereunder) to at least 50 percent of his accrued benefit derived from employer contributions.

(3) *Certain forfeitures.* Paragraph (b)(1) of this section does not apply in the case of a forfeiture permitted by section 411(a)(3)(D)(iii) and § 11.411(a)–4(b)(5)(i) (relating to forfeitures of certain benefits accrued before September 2, 1974).

[T.D. 7387, 40 FR 51421, Nov. 5, 1975]

§ 11.401(b)–1 Certain retroactive changes in plan.

(a) *General rule.* (1) Under section 401(b), a stock bonus, pension, profit-sharing or annuity plan or bond purchase plan which does not satisfy the requirements of section 401(a) on any day solely as a result of a disqualifying provision (as defined in paragraph (b) of this section) shall be considered to have satisfied such requirements on such day if there is adopted during the remedial amendment period (as determined under paragraphs (c) and (d) of this section) with respect to such disqualifying provision an amendment which causes the plan to satisfy all such requirements of section 401(a), 403(a) or 405(a) for the whole of the remedial amendment period (including extension thereof).

(2) This section shall not apply to any disqualifying provision if the remedial amendment period (as determined under paragraphs (c) and (d)(1) of this section determined without regard to paragraph (d)(2) of this section) with respect to such disqualifying provision ends prior to September 2, 1974.

(b) *Disqualifying provisions.* For purposes of this section, with respect to a plan described in paragraph (a) of this section the term ''disqualifying provision'' means any provision of—

(1) A plan as adopted,

(2) A plan amendment, or

(3) The Employee Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 829),

which causes such plan to fail to satisfy the requirements of section 401(a), 403(a), or 405(a).

(c) *Remedial amendment period.* (1) The remedial amendment period with respect to a disqualifying provision begins on the effective date of the disqualifying provision. For purposes of this section, the effective date of a disqualifying provision is—

(i) In the case of a disqualifying provision in a plan as adopted, the date the plan is put into effect,

(ii) In the case of a plan amendment, the date the plan amendment is adopted or put into effect (whichever is earlier), or

(iii) In the case of a statutory provision described in paragraph (b)(3) of this section, the effective date of such provision.

(2) Unless extended as provided by paragraph (d) of this section, the remedial amendment period ends with the time prescribed by law (including extensions) for filing the return of the employer for the employer's taxable year in which falls—

(i) With respect to a disqualifying provision in a plan as adopted, or a plan amendment, the later of the date on which such provision was adopted or put into effect.

(ii) With respect to a statutory provision described in paragraph (b)(3) of this section, the effective date of such provision.

(d) *Extension for determination letters*—(1) *In general.* If, before the end of the remedial amendment period (determined without regard to this paragraph) with respect to a disqualifying provision, the employer or plan administrator files a request pursuant to § 601.210(o) of this chapter (Statement of Procedural Rules) for a determination letter with respect to the initial qualifications of the plan or the effect of such disqualifying provision on the qualified status of the plan (or a trust which is part of a plan) under section 401(a), 403(a), or 405(a), then except as provided in subparagraph (3) of this paragraph, such remedial amendment period may be extended for a period not to exceed 150 days, beginning on the day after the last day of the employers

taxable year in which falls the dates described in subdivisions (i) and (ii) of paragraph (c)(2) of this section. The 150-day period does not include any day on which there is pending before the Internal Revenue Service a request for a determination letter described in this subparagraph. For this purpose, such a request is considered to be pending before the Internal Revenue Service from the date it is filed with the Internal Revenue Service to the date on which notice of the final determination with respect to the request is issued by the Internal Revenue Service, the request is withdrawn, or the request is otherwise finally disposed of by the Internal Revenue Service.

(2) *Special rules.* Except as provided in subparagraph (3) of this paragraph, the period provided by subparagraph (1) of this paragraph shall not end prior to the later of December 31, 1975, or the expiration of 30 days after—

(i) The date on which a notice of final determination with respect to a request described in that subparagraph is issued by the Internal Revenue Service, or, where applicable,

(ii) The date on which a judgment pursuant to section 7476 (relating to declaratory judgments) by the United States Tax Court in a case or controversy involving such determination becomes final.

(3) *Overall limitation.* The period provided by subparagraph (1) of this paragraph shall not expire later than the last day (determined under section 6501) for assessment of any tax imposed by the Internal Revenue Code with respect to the taxable year of the employer immediately preceding the first day of such period.

(Sec. 401(b), Internal Revenue Code of 1954, 88 Stat. 943 (26 U.S.C. 401(b)))

[T.D. 7377, 40 FR 44544, Sept. 29, 1975]

§11.401(d)(1)–1 Nonbank trustees of trusts benefiting owner-employees.

(a) *Effective dates*—(1) *General rule.* For a plan not in existence on January 1, 1974, this section shall apply to the first plan year commencing after September 2, 1974, and all subsequent plan years.

(2) *Existing plans.* For a plan in existence on January 1, 1974, this section shall apply to the first plan year commencing after December 31, 1975, and all subsequent plan years.

(b) *In general.* For plan years to which this section applies, the trustee of a trust described in §1.401–12(c)(1)(i) may (notwithstanding §1.401–12(c)) be a person other than a bank (within the meaning of section 401(d)(1)) if he demonstrates to the satisfaction of the Commissioner that the manner in which he will administer trusts will be consistent with the requirements of section 401. Such demonstration must be made by a written application to the Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, DC 20224. Such application must meet the requirements set forth in paragraphs (c) to (g) of this section.

(c) *Fiduciary ability.* The applicant must demonstrate in detail his ability to act within the accepted rules of fiduciary conduct. Such demonstration must include the following elements of proof:

(1) *Continuity.* (i) The applicant must assure the uninterrupted performance of its fiduciary duties notwithstanding the death or change of its owners. Thus, for example, there must be sufficient diversity in the ownership of the applicant to ensure that the death or change of its owners will not interrupt the conduct of its business. Therefore, the applicant cannot be an individual.

(ii) Sufficient diversity in the ownership of an incorporated applicant means that individuals each of whom owns more than 20 percent of the voting stock in the applicant own, in the aggregate, no more than 50 percent of such stock.

(iii) Sufficient diversity in the ownership of an applicant which is a partnership means that—

(A) Individuals each of whom owns more than 20 percent of the profits interest in the partnership own, in the aggregate, no more than 50 percent of such profits interest, and

(B) Individuals each of whom owns more than 20 percent of the capital interest in the partnership own, in the aggregate, no more than 50 percent of such capital interest.

(iv) For purposes of this subparagraph, the ownership of stock and of capital and profits interests shall be

determined in accordance with the rules for constructive ownership of stock provided in section 1563(e) and (f)(2). For this purpose, the rules for constructive ownership of stock provided in section 1563(e) and (f)(2). For this purpose, the rules for constructive ownership of stock provided in section 1563(e) and (f)(2) shall apply to a capital or profits interest in a partnership as if it were a stock interest.

(2) *Established location*. The applicant must have an established place of business in the United States where he is accessible during every business day.

(3) *Fiduciary experience.* The applicant must have fiduciary experience or expertise sufficient to ensure that he will be able to perform his fiduciary duties. Evidence of fiduciary experience must include proof that a significant part of the business of the applicant consists of exercising fiduciary powers similar to those he will exercise if his application is approved. Evidence of fiduciary expertise must include proof that the applicant employs personnel experienced in the administration of fiduciary powers similar to those he will exercise if his application is approved.

(4) *Fiduciary responsibility*. The applicant must assure compliance with the rules of fiduciary conduct set out in paragraph (f) of this section.

(5) *Financial responsibility*. The applicant must exhibit a high degree of solvency commensurate with the obligations imposed by this section. Among the factors to be taken into account are the applicant's net worth, his liquidity, and his ability to pay his debts as they come due.

(d) *Capacity to account.* The applicant must demonstrate in detail his experience and competence with respect to accounting for the interests of a large number of individuals (including calculating and allocating income earned and paying out distributions to payees). Examples of accounting for the interests of a large number of individuals include accounting for the interests of a large number of shareholders in a regulated investment company and accounting for the interests of a large number of variable annuity contract holders.

(e) *Fitness to handle funds*—(1) *In general.* The applicant must demonstrate in detail his experience and competence with respect to other activities normally associated with the handling of retirement funds.

(2) *Examples.* Examples of activities normally associated with the handling of retirement funds include:

(i) To receive, issue receipts for, and safely keep securities;

(ii) To collect income;

(iii) To execute such ownership certificates, to keep such records, make such returns, and render such statements as are required for Federal tax purposes;

(iv) To give proper notification regarding all collections;

(v) To collect matured or called principal and properly report all such collections;

(vi) To exchange temporary for definitive securities;

(vii) To give proper notification of calls, subscription rights, defaults in principal or interest, and the formation of protective committees;

(viii) To buy, sell, receive, or deliver securities on specific directions.

(f) *Rules of fiduciary conduct*—(1) *Administration of fiduciary powers.* The applicant must demonstrate that under applicable regulatory requirements, corporate or other governing instruments, or its established operating procedures:

(i)(A) The owners or directors of the applicant will be responsible for the proper exercise of fiduciary powers by the applicant. Thus, all matters pertinent thereto, including the determination of policies, the investment and disposition of property held in a fiduciary capacity, and the direction and review of the actions of all employees utilized by the applicant in the exercise of his fiduciary powers, will be the responsibility of the owners or directors. In discharging this responsibility, the owners or directors may assign to designated employees, by action duly recorded, the administration of such of the applicant's fiduciary powers as may be proper to assign.

(B) A written record will be made of the acceptance and of the relinquishment or closing out of all fiduciary accounts, and of the assets held for each account.

(C) At least once during each period of 12 months all the assets held in or for each fiduciary account where the applicant has investment responsibilities will be reviewed to determine the advisability of retaining or disposing of such assets.

(ii) All employees taking part in the performance of the applicant's fiduciary duties will be adequately bonded. Nothing in this subdivision shall require any person to be bonded in contravention of section 412(d) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1112(d)).

(iii) The applicant will designate, employ, or retain legal counsel who will be readily available to pass upon fiduciary matters and to advise the applicant.

(iv) In order to segregate the performance of his fiduciary duties from other business activities, the applicant will maintain a separate trust division under the immediate supervision of an individual designated for that purpose. The trust division may utilize the personnel and facilities of other divisions of the applicant, and other divisions of the applicant may utilize the personnel and facilities of the trust division, as long as the separate identity of the trust division is preserved.

(2) *Adequacy of net worth.* (i) Not less frequently than once during each calendar year the applicant will determine the value of the assets held by him in trust. Such assets will be valued at their current value, except that the assets of an employee benefit plan to which section 103(b)(3)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1023(b)(3)(A)) applies will be considered to have the value stated in the most recent annual report of the plan.

(ii) No fiduciary account will be accepted by the applicant unless his net worth (determined as of the end of the most recent taxable year) exceeds the greater of—

(A) $100,000, or

(B) Four percent of the value of all of the assets held by the applicant in trust (determined as of the most recent valuation date).

(iii) The applicant will take whatever lawful steps are necessary (including the relinquishment of fiduciary accounts) to ensure that his net worth (determined as of the close of each taxable year) exceeds the greater of—

(A) $50,000, or

(B) Two percent of the value of all of the assets held by the applicant in trust (determined as of the most recent valuation date).

(3) *Audits.* (i) The applicant will at least once during each period of 12 months cause detailed audits of the fiduciary books and records to be made by an independent qualified public accountant, and at such time will ascertain whether the fiduciary accounts have been administered in accordance with law, this section, and sound fiduciary principles. Such audits shall be conducted in accordance with generally accepted auditing standards, and shall involve such tests of the fiduciary books and records of the applicant as are considered necessary by the independent qualified public accountant.

(ii) In the case of an applicant who is regulated, supervised, and subject to periodic examination by a State or Federal agency, such applicant may adopt an adequate continuous audit system in lieu of the periodic audits required by paragraph (f)(3)(i) of this section.

(iii) A report of the audits and examinations required under this subparagraph, together with the action taken thereon, will be noted in the fiduciary records of the applicant.

(4) *Funds awaiting investment or distribution.* Funds held in a fiduciary capacity by the applicant awaiting investment or distribution will not be held uninvested or undistributed any longer than is reasonable for the proper management of the account.

(5) *Custody of investments.* (i) Except for investments pooled in a common investment fund in accordance with the provisions of paragraph (f)(6) of this section, the investments of each account will not be commingled with any other property.

(ii) Fiduciary assets requiring safekeeping will be deposited in an adequate vault. A permanent record will be kept of fiduciary assets deposited in or withdrawn from the vault.

(6) *Common investment funds.* Where not in contravention of local law the assets of an account may be pooled in

a common investment fund (as defined in paragraph (f)(8)(iii) of this section) which must be administered as follows:

(i) Each common investment fund must be established and maintained in accordance with a written agreement, containing appropriate provisions as to the manner in which the fund is to be operated, including provisions relating to the investment powers and a general statement of the investment policy of the applicant with respect to the fund; the allocation of income, profits and losses; the terms and conditions governing the admission or withdrawal of participations in the fund; the auditing of accounts of the applicant with respect to the fund; the basis and method of valuing assets in the fund, setting forth specific criteria for each type of asset; the minimum frequency for valuation of assets of the fund; the period following each such valuation date during which the valuation may be made (which period in usual circumstances may not exceed 10 business days); the basis upon which the fund may be terminated; and such other matters as may be necessary to define clearly the rights of participants in the fund. A copy of the agreement must be available at the principal office of the applicant for inspection during all business hours, and upon request a copy of the agreement must be furnished to any interested person.

(ii) All participations in the common investment fund must be on the basis of a proportionate interest in all of the assets.

(iii) Not less frequently than once during each period of 3 months applicant must determine the value of the assets in the fund as of the date set for the valuation of assets. No participation may be admitted to or withdrawn from the fund except (A) on the basis of such valuation and (B) as of such valuation date. No participation may be admitted to or withdrawn from the fund unless a written request for or notice of intention of taking such action has been entered on or before the valuation date in the fiduciary records of the applicant. No request or notice may be canceled or countermanded after the valuation date.

(iv)(A) The applicant must at least once during each period of 12 months cause an adequate audit to be made of the common investment fund by a qualified public accountant.

(B) The applicant must at least once during each period of 12 months prepare a financial report of the fund which, based upon the above audit, must contain a list of investments in the fund showing the cost and current market value of each investment; a statement for the period since the previous report showing purchases, with cost; sales, with profit or loss and any other investment changes; income and disbursements; and an appropriate notation as to any investments in default.

(C) The applicant must transmit and certify the accuracy of the financial report to the administrator of each plan participating in the common investment fund within 120 days after the end of the plan year.

(v) When participations are withdrawn from a common investment fund, distributions may be made in cash or ratably in kind, or partly in cash and partly in kind, provided that all distributions as of any one valuation date must be made on the same basis.

(vi) If for any reason an investment is withdrawn in kind from a common investment fund for the benefit of all participants in the fund at the time of such withdrawal and such investment is not distributed ratably in kind, it must be segregated and administered or realized upon for the benefit ratably of all participants in the common investment fund at the time of withdrawal.

(7) *Books and records.* (i) The applicant must keep his fiduciary records separate and distinct from other records. All fiduciary records must be so kept and retained for as long as the contents thereof may become material in the administration of any internal revenue law. The fiduciary records must contain full information relative to each account.

(ii) The applicant must keep an adequate record of all pending litigation to which he is a party in connection with the exercise of fiduciary powers.

(8) *Definitions.* For purposes of this paragraph and paragraph (c)(5) of this section—

(i) The term ''account'' or ''fiduciary account'' means a trust described in section 401(a) (including a custodial account described in section 401(f)), a custodial account described in section 403(b)(7), or an individual retirement account described in section 408(a) (including a custodial account described in section 408(h)).

(ii) The term ''administrator'' means an administrator as defined in section 3(16)(A) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002(16)(A).

(iii) The term ''common investment fund'' means a trust which satisfied the following requirements:

(A) The trust consists of all or part of the assets of several accounts which have been established with the applicant, and

(B) The trust is described in section 401(a) and exempt from tax under section 501(a), or is a common investment fund described in § 1.408–2(b)(5) (as published with notice of proposed rulemaking in the FEDERAL REGISTER on February 21, 1975, at 40 FR 7661), or both.

(iv) The term ''employee benefit plan'' means an employee benefit plan as defined in section 3(2) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002(2).

(v) The term ''fiduciary records'' means all matters which are written, transcribed, recorded, received or otherwise come into the possession of the applicant and are necessary to preserve information concerning the acts and events relevant to the fiduciary activities of the applicant.

(vi) The term ''qualified public accountant'' means a qualified public accountant as defined in section 103(a)(3)(D) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1023(a)(3)(D).

(vii) The term ''net worth'' means the amount of the applicant's assets less the amount of his liabilities, as determined in accordance with generally accepted accounting principles.

(g) *Special rules*—(1) *Passive trustee.* (i) An applicant who undertakes to act only as a passive trustee may be relieved of one or more of the requirements of this section upon clear and convincing proof that such requirements are not germane, under all the facts and circumstances, to the manner in which he will administer any trust. A trustee is a passive trustee only if under the written trust instrument he has no discretion to direct the investment of the trust funds or any other aspect of the business administration of the trust, but is merely authorized to acquire and hold particular investments specified by the trust instrument. Thus, for example, in the case of an applicant who undertakes merely to acquire and hold the stock of a single regulated investment company, the requirements of paragraphs (f)(1)(i)(C), (1)(iv), and (6) of this section shall not apply and no negative inference shall be drawn from the applicant's failure to demonstrate his experience or competence with respect to the activities described in paragraph (e)(2)(v) to (viii) of this section.

(ii) The determination letter issued to an applicant who is approved by reason of this subparagraph shall state that the applicant is authorized to act only as a passive trustee.

(2) *Federal or State regulation.* Evidence that an applicant is subject to Federal or State regulation with respect to one or more relevant factors shall be given weight in proportion to the extent that such regulatory standards are consonant with the requirements of section 401.

(3) *Savings account.* (i) An applicant will be approved to act as trustee under this subparagraph if the following requirements are satisfied:

(A) The applicant is a credit union, industrial loan company, savings and loan association, or other financial institution designated by the Commissioner;

(B) The investment of the trust assets will be solely in deposits in the applicant;

(C) Deposits in the applicant are insured (up to the dollar limit prescribed by applicable law) by an agency or instrumentality of the United States or a State.

(ii) Any applicant who satisfies the requirements of this subparagraph is hereby approved, and (notwithstanding paragraph (b) of this section) is not required to submit a written application. This approval takes effect on the first

day after December 22, 1976, on which the applicant satisfies the requirements of this subparagraph, and continues in effect for so long as the applicant continues to satisfy those requirements.

(4) *Notification of Commissioner.* The applicant must notify the Commissioner in writing of any change which affects the continuing accuracy of any representation made in the application required by this section, whether the change occurs before or after the applicant receives a determination letter. Such notification must be addressed to Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, D.C. 20224.

(5) *Substitution of trustee.* No applicant shall be approved unless he undertakes to act as trustee only under trust instruments which contain a provision to the effect that the employer is to substitute another trustee upon notification by the Commissioner that such substitution is required because the applicant has failed to comply with the requirements of this section or is not keeping such records, or making such returns, or rendering such statements as are required by forms or regulations.

(6) *Revocation.* Approval of the application required by this section may be revoked for any good and sufficient reason.

(Sec. 401(d)(1) and Internal Revenue Code of 1954 (88 Stat. 939 26 U.S.C. 401))

[T.D. 7383, 40 FR 48509, Oct. 16, 1975 as amended by T.D. 7448, 41 FR 55510, Dec. 21, 1976]

§ 11.402(e)(4)(A)–1 Lump sum distributions in the case of an employee who has separated from service.

(a) *Balance to the credit of an employee.* Section 402(e)(4)(A) provides that in order for a distribution or payment from a qualified plan to be a lump sum distribution, the distribution or payment must represent the employee's balance under the plan. The employee's balance does not include any amount which is forfeited under the plan (even though the amount may be reinstated) as of the close of the taxable year of the recipient within which the distribution is made. In addition, in the case of an employee who has separated from service, the employee's balance does not include an amount which is subject to forfeiture not later than the close of the plan year within which the employee incurs a one-year break in service (within the meaning of section 411) if—

(1) By reason of the break in service, the amount is actually forfeited at or prior to the close of that plan year, and

(2) The break in service occurs within 25 months after the employee's separation from service. In the case of a plan which uses the elapsed time method of crediting service, the break in service may occur within 25 months of the employee's severance from service. See Department of Labor regulations relating to the elapsed time method for the date an employee severs from service.

An employee may assume that an amount subject to forfeiture will be treated as forfeited by the date prescribed in paragraphs (a) (1) and (2) of this section if, under the plan, forfeiture will occur not later than that date. Therefore, he may assume that a distribution is a lump sum distribution at the time it is made, if the other requirements for lump sum distributions are satisfied. However, if the amount is not forfeited by that date, the amount will be taken into account in determining the balance to the credit of the employee. Accordingly, the distribution will not be a lump sum distribution because it did not include the employee's entire balance under the plan.

(b) *Rollover contribution.* As described in paragraph (a) of this section, an employee may assume that a distribution is a lump sum distribution even though part of the balance of his account has not been forfeited at the time the distribution is made. He may then roll the distribution over as a contribution to an individual retirement arrangement pursuant to section 402(a)(5) or 403(a)(4). It may be subsequently determined that the distribution was not a lump sum distribution because an amount subject to forfeiture was not in fact forfeited within the time required in paragraph (a) of this section. In that case, the contribution will be an excess contribution to the individual retirement arrangement, deemed made in the first taxable year of the employee in which it can be determined that an amount subject to forfeiture will not be forfeited.

(c) *Effective date.* This section is effective for distributions made in taxable years of recipients beginning after December 31, 1973.

[T.D. 7488, 42 FR 27882, June 1, 1977]

§ 11.402(e)(4)(B)–1 Election to treat an amount as a lump sum distribution.

(a) *In general.* For purposes of sections 402, 403, and this section, an amount which is described in section 402(e)(4)(A) and which is not an annuity contract may be treated as a lump sum distribution under section 402(e)(4)(A) only if the taxpayer elects for the taxable year to have all such amounts received during such year so treated. Not more than one election may be made under this section with respect to an employee after such employee has attained age 59½.

(b) *Taxpayers eligible to make the election.* Individuals, estates, and trusts are the only taxpayers eligible to make the election provided by this section. In the case of a lump sum distribution made with respect to an employee to 2 or more trusts, the election provided by this section shall be made by the employee or by the personal representative of a deceased employee.

(c) *Procedure for making election*—(1) *Time and scope of election.* An election under this section shall be made for each taxable year to which such election is to apply. The election shall be made before the expiration of the period (including extension thereof) prescribed in section 6511 for making a claim for credit or refund of the assessed tax imposed by Chapter I of Subtitle A of the Code for such taxable year.

(2) *Manner of making election.* An election by the taxpayer with respect to a taxable year shall be made by filing Form 4972 as a part of the taxpayer's income tax return or amended return for the taxable year.

(3) *Revocation of election.* An election made pursuant to this section may be revoked within the time prescribed in subparagraph (1) of this paragraph for making an election, only if there is filed, within such time, an amended income tax return for such taxable year, which includes a statement revoking the election and is accompanied by payment of any tax attributable to the revocation. If an election for a taxable year is revoked, another election may be made for that taxable year under subparagraphs (1) and (2) of this paragraph.

(Sec. 402(e)(4)(B) of the Internal Revenue Code of 1954 (88 Stat. 989, 26 U.S.C. 402(e)(4)(B)))

[T.D. 7339, 40 FR 1016, Jan. 6, 1975]

§ 11.404(a)(6)–1 Time when contributions to "H.R. 10" plans considered made.

(a) *In general.* Section 404(a)(6), as amended by section 1013(c)(2) of the Employee Retirement Income Security Act of 1974, provides that for purposes of paragraphs (1), (2), and (3) of section 404(a), a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). Under section 1017(b) of the Employee Retirement Income Security Act of 1974 (prior to its amendment by the Tax Reduction Act of 1975), in the case of a plan which was in existence on January 1, 1974, the foregoing provision generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after December 31, 1975. In the case of a plan not in existence on January 1, 1974, the foregoing provision generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after September 2, 1974. See § 11.410(a)–2(c) for time a plan is considered in existence. See also § 11.410(a)–2(d), which provides that a plan in existence on January 1, 1974 may elect to have certain provisions, including the amendment to section 404(a)(6) contained in section 1013 of the Employee Retirement Income Security Act of 1974, apply to a plan year beginning after September 2, 1974, and before the otherwise applicable effective date contained in that section.

(b) *''H.R. 10'' plans may elect new provision.* Under section 402 of the Tax Reduction Act of 1975 (89 Stat. 47), in the case of a plan which was in existence on January 1, 1974, and which provides contributions or benefits for employees

some or all of whom are employees within the meaning of section 401(c)(1) of the Code and § 1.401–10(b), the provision described in paragraph (a) of this section shall apply for taxable years of an employer ending with or within plan years beginning after December 31, 1974, but only if the employer (within the meaning of section 401(c)(4) of the Code and § 1.401–10(e)) elects to have such provisions apply as provided in paragraph (c) of this section.

(c) *Manner of election.* The election described in paragraph (b) of this section shall be considered to be made if the employer (as described in paragraph (b) of this section)—

(1) Makes a contribution which relates to his preceding taxable year within the time prescribed in paragraph (a) of this section to a plan described in paragraph (b) of this section, and

(2) Claims a deduction for such contribution on his tax return for such year (or, in the case of a contribution by a partnership on behalf of a partner, the contribution is shown on Schedule K of the partnership tax return for such year); no formal statement is necessary. In the case of an employer whose income tax return for the year on account of which the payment is made is required to be filed (determined without regard to extensions of time) on or before April 15, 1976, and who made a payment within the time prescribed in paragraph (a) of this section, the election also may be made by filing an amended return or claim for refund with respect to such year on or before September 30, 1976.

(d) *Election is irrevocable.* Any election made under paragraph (c) of this section, once made, shall be irrevocable.

(e) *Examples.* The rules of this section are illustrated by the following examples.

Example (1). On October 15, 1976, the ABC Partnership made a contribution to the ABC Profit Sharing Plan and Trust on behalf of partners and common-law employees with respect to the plan year ending December 31, 1975. The ABC Profit Sharing Trust was exempt under section 501 (a) throughout 1975. The contribution for both partners and employees was reflected on the partnership return for the calendar year 1975 which was filed on October 10, 1976; proper extensions of the due date of the partnership return had been received, extending the due date to October 15, 1976. The election is valid since all requirements of this section have been met.

Example (2). The XYZ Partnership made a plan contribution on April 10, 1976, with respect to the plan year ending December 31, 1975, but the amount contributed for 1975 was not reflected in the partnership return filed for the calendar year 1975 on April 15, 1976. However, the XYZ Partnership filed an amended partnership return for the year 1975 on September 30, 1976, claiming a deduction for the employee-related contribution and setting forth on Schedule K the contribution relating to partners. The election is valid, since the contribution on account of 1975 was made within the time required, and was shown on the amended tax return of the employer for 1975 filed within the time prescribed in paragraph (c)(2) of this section.

Example (3). Mr. Smith, a sole proprietor whose taxable year is the calendar year, made a contribution to the Smith Profit Sharing Plan and Trust on April 15, 1976, for the plan year which began December 1, 1974, and ended November 30, 1975. The plan was in existence on January 1, 1974. Since the contribution was made within the time prescribed by this section and was on account of a taxable year of the employer ending within a plan year which began after December 31, 1974, the contribution may be deducted on Mr. Smith's return for 1975, even though the contribution was for a plan year beginning before December 31, 1974.

Example (4). The DEF Partnership, reporting its income on the basis of a fiscal year ending June 30, made a contribution to its ''H.R. 10'' plan which was in existence on January 1, 1974, and whose plan year was the calendar year. The contribution was made on September 30, 1975, and was on account of the taxable year of the partnership ending June 30, 1975. The contribution was properly reflected in the partnership return for the fiscal year ending June 30, 1975. The partnership's election to have section 404(a)(6), as amended, apply to its fiscal year ending June 30, 1975, is valid since that year ended with or within a plan year beginning after December 31, 1974.

[T.D. 7402, 41 FR 5633, Feb. 9, 1976]

§ 11.408(a)(2)–1 Trustee of individual retirement accounts.

A person may demonstrate to the satisfaction of the Commissioner that the manner in which he will administer the trust will be consistent with the requirements of section 408 only upon the filing of a written application to the

Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, D.C. 20224. Such application must meet the applicable requirements of the regulations under section 401(d)(1) relating to nonbank trustees of pension and profit-sharing trusts benefiting owner-employees.

(Sec. 408(a)(2) of the Internal Revenue Code of 1954 (88 Stat. 959, 26 U.S.C. 408(a)(2)))

[T.D. 7390, 40 FR 53580, Nov. 19, 1975]

§ 11.410–1 Election by church to have participation, vesting, funding, etc., provisions apply.

(a) *In general.* If a church or convention or association of churches which maintains any church plan, as defined in section 414(e), makes an election under this section, certain provisions of the Code and Title I of the Employee Retirement Income Security Act of 1974 (the ''Act'') shall apply to such church plan as if such plan were not a church plan. The provisions of the Code referred to are section 410 (relating to minimum participation standards), section 411 (relating to minimum vesting standards), section 412 (relating to minimum funding standards), section 4975 (relating to prohibited transactions), and paragraphs (11), (12), (13), (14), (15), and (19) of section 401(a) (relating to joint and survivor annuities, mergers and consolidations, assignment or alienation of benefits, time of benefit commencement, certain social security increases, and withdrawals of employee contributions, respectively).

(b) *Election is irrevocable.* An election under this section with respect to any church plan shall be binding with respect to such plan and, once made, shall be irrevocable.

(c) *Procedure for making election*— (1) *Time of election.* An election under this section may be made for plan years for which the provisions of section 410(d) of the Code apply to the church plan. By reason of section 1017(b) of the Act section 410(d) does not apply to a plan in existence on January 1, 1974, for plan years beginning before December 31, 1975. Section 1017(d) of the Act permits a plan administrator to elect to have certain provisions of the Code (including section 410(d)) apply to a plan before the otherwise applicable effective dates of such provisions. See § 420.0–1 of the regulations in this chapter (Temporary Regulations on Procedure and Administration under the Employee Retirement Income Security Act of 1974). Therefore, an election under section 410(d) of the Code may be made for a plan year beginning before December 31, 1975, only if an election has been made under section 1017(d) of the Act with respect to that plan year.

(2) *By whom election is to be made.* The election provided by this section may be made only by the plan administrator of the church plan.

(3) *Manner of making election.* The plan administrator may elect to have the provisions of the Code described in paragraph (a) of this section apply to the church plan as if it were not a church plan by attaching the statement described in subparagraph (5) of this paragraph to either (i) the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective or (ii) a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and, if trusteed, the exempt status under section 501(a) of the Code of a trust constituting a part of the plan.

(4) *Conditional election.* If an election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter.

(5) *Statement.* The statement described in subparagraph (3) of this paragraph shall indicate (i) that the election is made under section 410(d) of the Code and (ii) the first plan year for which it is effective.

(Sec. 410(d), Internal Revenue Code, 1954 (88 Stat. 901; 26 U.S.C. 410(d)))

[T.D. 7363, 40 FR 27217, June 27, 1975]

§ 11.410(b)–1 Minimum coverage requirements.

(a)–(c) [Reserved]

(d) *Special rules.* (1) [Reserved]

(2) *Discrimination.* The determination as to whether a plan discriminates in favor of employees who are officers, shareholders, or highly compensated, is

made on the basis of the facts and circumstances of each case, allowing a reasonable difference between the percentage of such employees benefited by the plan to all employees benefited by the plan and the percentage of all such employees of the employer to all employees of the employer. A showing that a specified percentage of employees covered by a plan are not officers, shareholders, or highly compensated, without a showing that the difference (if any) between such percentage and the percentage of all employees who are not officers, shareholders, or highly compensated is reasonable, is not sufficient to establish that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

(Sec. 410, Internal Revenue Code of 1954 (88 Stat. 898; 26 U.S.C. 410))

[T.D. 7380, 40 FR 45816, Oct. 3, 1975, as amended by T.D. 7508, 42 FR 47197, Sept. 20, 1977]

§ 11.412(c)–7 Election to treat certain retroactive plan amendments as made on the first day of the plan year.

(a) *General rule.* Under section 412(c)(8), a plan administrator may elect to have any amendment which is adopted after the close of the plan year to which it applies deemed to have been made on the first day of such plan year if the amendment—

(1) Is adopted no later than 2 and one-half months after the close of such plan year (or, in the case of a multiemployer plan, no later than 2 years after the close of such plan year),

(2) Does not reduce the accrued benefit of any participant determined as of the beginning of such plan year, and

(3) Does not reduce the accrued benefit of any participant determined as of the time of adoption of the amendment, or, if it does so reduce such accrued benefit, it is shown that the plan administrator filed a notice with the Secretary of Labor notifying him of the amendment, and—

(i) The Secretary of Labor approved the amendment, or

(ii) The Secretary of Labor failed to disapprove the amendment within 90 days after the date on which the notice was filed.

(b) *Time and manner of making election.* (1) The election under section 412(c)(8) shall be made by the plan administrator by a statement of election described in subparagraph (3) of this paragraph, attached to the annual return relating to minimum funding standards required to be filed under section 6058 with respect to the plan year to which the election relates.

(2) In the event that an amendment to which paragraph (a) of this section applies is adopted after the filing of the annual return required under section 6058, the plan administrator may make the election under section 412(c)(8) by attaching a statement of election, described in paragraph (b)(3) of this section, to a copy of such annual return, and filing such copy no later than the time allowed for the filing of such returns under section 6058. (In the case of multiemployer plans, such copy may be filed within a 24 month period beginning with the date prescribed for the filing of such returns.)

(3) The statement of election filed by or on behalf of the plan administrator shall—

(i) State the date of the close of the first plan year to which the amendment applies and the date on which the amendment was adopted;

(ii) Contain a statement that the amendment does not reduce the accrued benefit of any participant determined as of the beginning of the plan year preceding the plan year in which the amendment is adopted; and

(iii) Contain either—

(A) A statement that the amendment does not reduce the accrued benefit of any participant determined as of the time of adoption of such amendment, or

(B) A copy of the notice filed with the Secretary of Labor under section 412(c)(8) and a statement that either the Secretary of Labor has approved the amendment or he has failed to act within 90 days after notification of the amendment.

[T.D. 7338, 39 FR 44751, Dec. 27, 1974]

§ 11.412(c)–11 Election with respect to bonds.

(a) *In general.* Section 412(c)(2)(B) provides that, at the election of the administrator of a plan which includes a

trust qualified under section 401(a) or of a plan which satisfies the requirements of section 403(a) or section 405(a), the value of a bond or other evidence of indebtedness which is held by the plan and which is not in default as to principal or interest may be determined on an amortized basis running from initial cost at purchase to the amount payable at maturity (or, in the case of a bond which is callable prior to maturity, the earliest call date). So long as this election is in effect, the value of any such evidence of indebtedness shall, for purposes of section 412, be determined on such an amortized basis rather than on a method taking into account fair market value as described in section 412(c)(2)(A).

(b) *Manner of making election.* The election to value evidences of indebtedness in accordance with paragraph (a) of this section shall be made by a statement to that effect attached to and filed as a part of the annual return of the plan required under section 6058 of the Code.

(c) *Effect of election.* The election provided by section 412(c)(2)(B), once made, will affect the valuation of all evidences of indebtedness, not in default as to principal or interest, which are held by the plan for the plan year for which the election is made and any evidences of indebtedness which are subsequently acquired by the plan. The value of any evidence of indebtedness which is in default as of the valuation date for the plan year must be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value in accordance with section 412(c)(2)(A) and must continue to be so valued until the indebtedness is no longer in default.

(d) *Consent to revoke required*—(1) *In general.* An election made in accordance with paragraph (a) of this section may be revoked only if consent to revoke the election is obtained from the Secretary or his delegate.

(2) *Manner of obtaining permission for revocation.* [Reserved]

(Secs. 302(c)(2)(B), 412(c)(2)(B) of the Internal Revenue Code of 1954 (88 Stat. 871, 914))

[T.D. 7335, 39 FR 44009, Dec. 20, 1974]

§ 11.412(c)–12 Extension of time to make contributions to satisfy requirements of section 412.

(a) *In general.* Section 412(c)(10) of the Internal Revenue Code of 1954 provides that for purposes of section 412 a contribution for a plan year made after the end of such plan year but not later than two and one-half months after the last day of such plan year shall be deemed to have been made on such last day. Section 412(c) (10) further provides that the two and one-half month period may be extended for not more than six months under regulations.

(b) *Six month extension of two and one-half month period.* (1) For purposes of section 412 a contribution for a plan year to which section 412 applies that is made not more than eight and one-half months after the end of such plan year shall be deemed to have been made on the last day of such year.

(2) The rules of this section relating to the time a contribution to a plan is deemed made for purposes of the minimum funding standard under section 412 are independent from the rules contained in section 404(a) (6) relating to the time a contribution to a plan is deemed made for purposes of claiming a deduction for such contribution under section 404.

(Sec. 412(c)(10), Internal Revenue Code of 1954 (88 Stat. 917; 26 U.S.C. 412(c)(10)))

[T.D. 7439, 41 FR 46597, Oct. 22, 1976]

§ 11.415(c)(4)–1 Special elections for section 403(b) annuity contracts purchased by educational institutions, hospitals and home health service agencies.

(a) *Limitations applicable to contributions for section 403(b) annuity contracts*—(1) *In general.* An annuity contract described in section 403(b) which is treated as a defined contribution plan (as defined in section 414(i)) is subject to the rules regarding the amount of annual additions (as defined in section 415(c)(2)) that may be made to a participant's account in a defined contribution plan for any limitation year (as defined in subparagraph (2) of this paragraph) under section 415(c)(1) and Revenue Ruling 75–481, 1975–2 C.B. 188. An annual addition to the account of

an individual under a section 403(b) annuity contract in excess of such limitation for a limitation year is includible in the gross income of the individual for the taxable year with or within which such limitation year ends and reduces the exclusion allowance under section 403(b)(2) for such taxable year to the extent of the excess. Such annuity contracts are, of course, also subject to the limitation imposed by section 403(b)(2) with respect to the amount that may be contributed by the employer for the purchase of an annuity contract described in section 403(b) and be excluded from the gross income of the employee on whose behalf such annuity contract is purchased. In general, the excludable contribution for such an annuity contract for a particular taxable year is the lesser of the exclusion allowance computed under section 403(b)(2) for such taxable year or the limitation imposed by section 415(c)(1) for the limitation year ending with or within such taxable year. For purposes of the limitation imposed by section 415(c)(1), the amount contributed toward the purchase of an annuity contract described in section 403(b) is treated as allocated to the employee's account as of the last day of the limitation year ending with or within the taxable year during which such contribution is made.

(2) *Limitation year.* For purposes of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, the limitation year applicable to an individual on whose behalf an annuity contract described in section 403(b) has been purchased by an employer shall be the calendar year unless such individual elects to change the limitation year to another 12-month period and attaches a statement to his income tax return filed for the taxable year in which such change is made.

(ii) The limitation year applicable to an individual described in subdivision (i) of this subparagraph who is in control (within the meaning of section 414 (b) or (c) as modified by section 415(h)) of any employer shall be the same as the limitation year of such employer.

(3) *Special elections.* Under section 415(c)(4), special elections are permitted with respect to section 403(b) annuity contracts (including custodial accounts treated as section 403(b) annuity contracts under section 403(b)(7)) purchased by educational institutions (as defined in section 151(e)(4) and the regulations thereunder), home health service agencies (as defined in subparagraph (4) of this paragraph) and hospitals. In lieu of the limitation described in section 415(c)(1)(B) otherwise applicable to the annual addition (as defined in section 415(c)(2)) that may be made to the account of a participant in a qualified defined contribution plan for a particular limitation year, an individual for whom an annuity contract described in this subparagraph is purchased may elect, in accordance with the provisions of paragraph (b) of this section, to have substituted for such limitation the amounts described in subparagraph (5)(i) or (5)(ii) of this paragraph. In lieu of the exclusion allowance determined under section 403(b)(2) and the regulations thereunder otherwise applicable for the taxable year with or within which the limitation year ends to an individual on whose behalf an annuity contract described in this subparagraph is purchased, such an individual may elect, in accordance with the provisions of paragraph (b) of this section, to have substituted for such exclusion allowance the amount described in subparagraph (5)(iii) of this paragraph.

(4) *Definition.* For purposes of this section, a home health service agency is an organization described in section 501(c)(3) which is exempt from taxation under section 501(a) and which has been determined by the Secretary of Health, Education, and Welfare to be a home health agency under section 1395(x)(o) of Title 42 of the United States Code.

(5) *Elections.* (i) For the limitation year that ends with or within the taxable year in which an individual separates from the service of his employer (and only for such limitation year), the ''(A) election limitation'' shall be the exclusion allowance computed under section 403(b)(2)(A) and the regulations thereunder (without regard to section 415) for the taxable year in which such separation occurs taking into account such individual's years of service (as defined in section 403(b)(4) and the regulations thereunder) for the employer

and contributions described in section 403(b)(2)(A)(ii) and the regulations thereunder during the period of years (not exceeding 10) ending on the date of separation. For purposes of the preceding sentence, all service for the employer performed within such period must be taken into account. However, the ''(A) election limitation'' shall not exceed the amount described in section 415(c)(1)(A) (as adjusted under section 415(d)(1)(B)) applicable to such individual for such limitation year.

(ii) For any limitation year, the ''(B) election limitation'' shall be equal to the least of the following amounts—

(A) $4,000, plus 25 percent of the individual's includable compensation (as defined in section 403(b)(3) and the regulations thereunder) for the taxable year with or within which the limitation year ends,

(B) The amount of the exclusion allowance determined under section 403(b)(2)(A) and the regulations thereunder for the taxable year with or within which such limitation year ends, or

(C) $15,000.

(iii) For any taxable year, the ''(C) election limitation'' shall equal the lesser of the amount described in section 415(c)(1)(A) (as adjusted under section 415(d)(1)(B)) or the amount described in section 415(c)(1)(B) applicable to the individual for the limitation year ending with or within such taxable year. For purposes of the preceding sentence, compensation described in section 415(c)(1)(B) taken into account for a particular limitation year does not include amounts contributed toward the purchase of an annuity contract described in section 403(b) during such limitation year (whether or not includable in the gross income of the individual on whose behalf such contribution is made).

(b) *Special rules for elections and salary reduction agreements for years before final regulations are published*—(1) *Election.* (i) For a limitation year which ends before or with or within the taxable year in which applicable final regulations under section 415 are first published in the FEDERAL REGISTER, an individual may wish to take advantage of the alternative limitations described in section 415(c)(4). One way of doing this is to attach a statement of intention to his individual tax return for the taxable year. The statement should provide that the individual intends to elect one of those alternative limitations. It should also specify which alternative he intends to elect. No form is prescribed for the statement of intention, but it must include the individual's name, address and Social Security number. If the individual is not required to file an income tax return for the taxable year to which the statement of intention is to apply, the statement of intention may still be filed at the Internal Revenue Service Center where that individual would file the return if he were required to file. It should be filed by the time he would have filed his return. The Internal Revenue Service will treat the statement of intention as an actual election for all taxable years through the taxable year in which applicable final regulations under section 415 are first published in the FEDERAL REGISTER for all purposes, except that it will not be irrevocable. If, pursuant to this subdivision, an individual takes advantage of an alternative limitation for a taxable year, then, except as provided in paragraph (b)(1)(iii) of this section, the individual may not take advantage of any other alternative limitation pursuant to this subdivision for any taxable year. If an individual does not file a statement of intention, he will still be able to take advantage of the alternative limitations for these taxable years. He will be able to do this if he determines his income tax liability for the taxable year in a way which is consistent with one of the alternative limitations.

(ii) The actual election for all taxable years through the taxable year in which applicable final regulations under section 415 are first published in the FEDERAL REGISTER will be made by filing the election with the Internal Revenue Service at the time and in the manner to be described by final regulations under section 415.

(iii) When an individual makes the actual election for any taxable year through the taxable year in which applicable final regulations under section

415 are published in the FEDERAL REGISTER, he may choose any of the alternative limitations, even if his choice is inconsistent with the alternative limitation which he used in determining his income tax liability for that taxable year. He may also choose not to elect any of the alternative limitations, even if he used one of them in determining his income tax liability for that taxable year. However, if his choice is different from the choice which he used in determining his income tax liability for the taxable year, there may be an adjustment in his tax for that year. For purposes of section 6654 (relating to failure of an individual to pay estimated tax), a difference in tax for such a year resulting from a difference in these choices will not be treated as an underpayment. This rule applies to the extent the difference in tax is due to the actual election of one of the alternative limitations or to a final decision not to use one of the alternative limitations for the taxable year.

(2) *Salary reduction agreements for 1976 and 1977.* (i) An individual who is employed by an organization described in paragraph (a)(3) may make a salary reduction agreement for his taxable year beginning in 1976 or 1977 at any time before the end of the 1976 or 1977 taxable year, respectively, without the agreement's being considered a new agreement within the meaning of § 1.403(b)–1(b)(3)(i). The agreement for 1976 may be made on or before June 15, 1977, if that date is later than the end of the individual's 1976 taxable year. The agreement for 1977 may be made on or before April 17, 1978, if that date is later than the end of the individual's 1977 taxable year.

(ii) This subparagraph applies only if the individual actually elects one of the alternative limitations under section 415(c)(4) for 1976 or 1977 (as the case may be).

(iii) The salary reduction agreement for 1976 may be made effective with respect to any amount earned during the taxpayer's most recent one-year period of service (as described in § 1.403(b)–1(f)) ending not later than the end of the 1976 taxable year, notwithstanding § 1.403(b)–1(b)(3)(i). Similarly, the salary reduction agreement for 1977 may be made effective with respect to such period of service ending not later than the end of the 1977 taxable year.

(iv) If the salary reduction agreement for 1976 is entered into at any time after December 31, 1976, or if the salary reduction agreement for 1977 is entered into at any time after December 31, 1977, an amended Form W–2 must be filed on behalf of the individual.

(3) *Election is irrevocable.* The election described in paragraph (a)(3) of this section, once made in accordance with the provisions of subparagraph (1) of this paragraph, shall be irrevocable with respect to the limitation years or taxable years to which such election relates.

(4) *Limitations.* With respect to any limitation or taxable year, an election by an individual pursuant to subparagraph (1) of this paragraph to have any subdivision of paragraph (a)(5) of this section apply to contributions made on his behalf by his employer with respect to any section 403(b) annuity contract will preclude an election to have any other subdivision of paragraph (a)(5) apply for any future limitation or taxable year with respect to any section 403(b) annuity contract contributions made by any employer of such individual. With respect to any limitation year, an election by an individual to have paragraph (a)(5)(i) of this section apply to contributions made on his behalf by his employer with respect to any section 403(b) annuity contract will preclude an election to have any subdivision of paragraph (a)(5) apply for any future limitation or taxable year with respect to any section 403(b) annuity contract contributions made by any employer of such individual.

(5) *Aggregation rules*—(i) *Annuity contracts described in section 403(b).* For purposes of applying the limitations of this section for a particular limitation or taxable year, all contributions toward the purchase of annuity contracts described in section 403(b) made on behalf of an individual by his employer and any related employer (as defined in subdivision (ii) of this subparagraph) must be aggregated without regard to:

(A) Whether such individual makes any election pursuant to subparagraph (1) of this paragraph for such year; and

(B) Whether such individual files a statement of intention pursuant to subparagraph (1) of this paragraph, for such year. In addition, any other aggregation required by Revenue Ruling 75–481, 1975–2 C.B. 188, must be made to the extent applicable.

(ii) *Definition.* For purposes of this section, with respect to a particular employer, a related employer is any other employer which is a member of a controlled group of corporations (as defined in section 414(b), and the regulations thereunder and as modified by section 415(h)) or a group of trades or business (whether or not incorporated) under common control (as defined in section 414(c) and the regulations thereunder and as modified by section 415(h)) in which such particular employer is a member.

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

Example (1). Doctor M is an employee of H Hospital (an organization described in section 501(c)(3) and exempt from taxation under section 501(a)) for the entire 1976 calendar year. M is not in control of H within the meaning of section 414 (b) or (c), as modified by section 415(h). M uses the calendar year as the taxable year and M uses the calendar year as the limitation year. M has includible compensation (as defined in section 403(b)(3) and the regulations thereunder) and compensation (as defined in section 415(c)(3)) for taxable year 1976 of $30,000, and M has 4 years of service (as defined in § 1.403(b)–1(f)) with H as of December 31, 1976. During M's prior service with H, H had contributed a total of $12,000 on M's behalf for annuity contracts described in section 403(b), which amount was excludable from M's gross income for such prior years. Thus, for the limitation year ending with or within taxable year 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $12,000 ((.20×$30,000×4) −$12,000). The limitation imposed by section 415(c)(1) that is applicable to M for limitation year 1976 is the lesser of $26,825 (the amount described in section 415(c)(1)(A) adjusted under section 415(d)(1)(B) for limitation year 1976) or $7,500 (the amount described in section 415(c)(1)(B)). Absent the special elections provided in section 415(c)(4), $7,500 would be the maximum contribution H could make for annuity contracts described in section 403(b) on M's behalf for limitation year 1976 without increasing M's gross income for taxable year 1976. However, because H is an organization described in section 415(c)(4), M may make a special election with respect to amounts contributed by H on M's behalf for section 403(b) annuity contracts for 1976. Assume that M does not separate from the service of H during 1976 and that, therefore, the ''(A) election limitation'' described in section 415(c)(4)(A) is not available to M. If M elects the ''(B) election limitation'' for 1976, H could contribute $11,500 on M's behalf for annuity contracts described in section 403(b) for that year (the least of $11,500 (the amount described in section 415(c)(4) (B)(i)); $12,000 (the amount described in section 415(c)(4)(B)(ii)), and $15,000 (the amount described in section 415(c)(4)(B)(iii))). If M elects the ''(C) election limitation'' for 1976, H could only contribute up to $7,500 (the lower of the amounts described in section 415(c)(1) (A) or (B)) for section 403(b) annuity contracts on M's behalf for 1976 without increasing M's gross income for that year.

Example (2). Assume the same facts as in example (1) except that H had contributed a total of $18,000 on M's behalf for annuity contracts in prior years, which amount was excludable from M's gross income for such prior years. Accordingly, for 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $6,000 ((.20×$30,000×4) −$18,000). The limitation imposed by section 415(c)(1) applicable to M for 1976 is $7,500 (the lesser of the amount described in section 415(c)(1) (A) or (B)). Absent the special elections provided in section 415(c)(4), $6,000 would be the maximum amount H could contribute for annuity contracts described in section 403(b) on M's behalf for 1976 without increasing M's gross income for that year. However, if M elects the ''(C) election limitation'' for 1976, H may contribute up to $7,500 without increasing M's gross income for that year.

Example (3). G, a teacher, is an employee of E, an educational institution described in section 151(e)(4). G uses the calendar year as the taxable year and G uses the 12-month consecutive period beginning July 1 as the limitation year. G has includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for taxable year 1976 of $12,000 and G has compensation (as defined in section 415(c)(3)) for the limitation year ending with or within taxable year 1976 of $12,000. G has 20 years of service (as defined in § 1.403(b)–1(f)) as of May 30, 1976, the date G separates from the service of E. During G's service with E before taxable year 1976, E had contributed $34,000 toward the purchase of a section 403(b) annuity contract on G's behalf, which amount was excludable from G's gross income for such prior years. Of this amount, $19,000 was so contributed and excluded during the 10 year period ending on May 30, 1976. For the taxable year 1976, G's exclusion allowance determined under section 403(b)(2)(A) is $14,000 ((.20×$12,000×20) −$34,000). Absent the special elections described in section 415(c)(4), $3,000 (the lesser of G's exclusion allowance for taxable year

1976 or the section 415(c)(1) limitation applicable to G for the limitation year ending with or within such taxable year) would be the maximum excludable contribution E could make for section 403(b) annuity contracts on G's behalf for the limitation year ending with or within taxable year 1976. However, because E is an organization described in section 415(c)(4), G may make a special election with respect to amounts contributed on G's behalf by E for section 403(b) annuity contracts for the limitation year ending with or within taxable year 1976. Because G has separated from the service of E during such taxable year, G may elect the ''(A) election limitation'' as well as the ''(B) election limitation'' or the ''(C) election limitation''. If G elects the ''(A) election limitation'' for the limitation year ending with or within taxable year 1976, E could contribute up to $5,000 ((.20×$12,000×10) −$19,000) on G's behalf for section 403(b) annuity contracts for such limitation year without increasing G's gross income for the taxable year with or within which such limitation year ends. If G elects the ''(B) election limitation'' for such limitation year, E could contribute $7,000 (the least of $7,000 (the amount described in section 415(c)(4)(B)(i)); $14,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii))). If G elects the ''(C) election limitation'' for taxable year 1976, E could contribute $3,000 (the lesser of the amounts described in section 415(c)(1) (A) or (B)).

(d) *Plan year.* For purposes of section 415 and this section, an annuity contract described in section 403(b) shall be deemed to have a plan year coinciding with the taxable year of the individual on whose behalf the contract has been purchased unless that individual demonstrates that a different 12-month period should be considered to be the plan year.

(e) *Effective date.* The provisions of this section are applicable for taxable years beginning in and for limitation years ending with or within taxable years beginning in 1976.

(Sec. 415(c)(4)(D) of the Internal Revenue Code of 1954 (88 Stat. 983; 26 U.S.C. 415(c)(4)(D)))

[T.D. 7442, 41 FR 52296, Nov. 29, 1976, as amended by T.D. 7531, 43 FR 1065, Jan. 6, 1978]

PART 12—TEMPORARY INCOME TAX REGULATIONS UNDER THE REVENUE ACT OF 1971

Sec.

12.3 Investment credit, public utility property elections.
12.4 Election of Class Life Asset Depreciation Range System (ADR).
12.7 Election to be treated as a DISC.
12.8 Elections with respect to net leases of real property.
12.9 Election to postpone determination with respect to the presumption described in section 183(d).

AUTHORITY: 26 U.S.C. 167, 263, and 7805.

§ 12.3 Investment credit, public utility property elections.

(a) *Elections*—(1) *In general.* Under section 46(e), three elections may be made on or before March 9, 1972, with respect to section 46(e) property (as defined in subparagraph (3) of this paragraph). An election made under the provisions of section 46(e) shall be irrevocable.

(2) *Applicability of elections.* (i) Any election under section 46(e) shall be made with respect to all of the taxpayer's property eligible for the election whether or not the taxpayer is regulated by more than one regulatory body.

(ii)*(a)* Paragraph (1) of section 46(e) shall apply to all of the taxpayer's section 46(e) property in the absence of an election under paragraph (2) or (3) of section 46(e). If an election is made under paragraph (2) of section 46(e), paragraph (1) of such section shall not apply to any of the taxpayer's section 46(e) property.

(b) An election made under the last sentence of section 46(e)(1) shall apply to that portion of the taxpayer's section 46(e) property to which paragraph (1) of section 46(e) applies and which is short supply property within the meaning of § 1.46–5(b)(2) of this chapter (Income Tax Regulations) as set forth in a notice of proposed rule making published in 37 FR 3526 on February 17, 1971.

(iii) If a taxpayer makes an election under paragraph (2) of section 46(e), and makes no election under paragraph (3) of such section, the election under paragraph (2) of section 46(e) shall apply to all of its section 46(e) property.

(iv) If a taxpayer makes an election under paragraph (3) of section 46(e), such election shall apply to all of the taxpayer's section 46(e) property to

which section 167(l)(2)(C) applies. Paragraph (1) or (2) of section 46(e) (as the case may be) shall apply to that portion of the taxpayer's section 46(e) property which is not property to which section 167(l)(2)(C) applies. Thus, for example, if a taxpayer makes an election under paragraph (2) of section 46(e), and also makes an election under paragraph (3) of section 46(e), paragraph (3) shall apply to all of the taxpayer's section 46(e) property to which section 167(l)(2)(C) applies and paragraph (2) shall apply to the remainder of the taxpayer's section 46(e) property.

(3) *Section 46(e) property.* ''Section 46(e) property'' is section 38 property which is both property described in section 50 and is—

(i) Public utility property within the meaning of section 46(c)(3)(B) (other than nonregulated communication property of the type described in the last sentence of section 46(c)(3)(B)), or

(ii) Property used predominantly in the trade or business of the furnishing or sale of *(a)* steam through a local distribution system or *(b)* the transportation of gas or steam by pipeline, if the rates for such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in section 46(c)(3)(B).

(b) *Method of making elections.* A taxpayer may make the elections described in section 46(e) by filing a statement, on or before March 9, 1972, with the district director or director of the internal revenue service center with whom the taxpayer ordinarily files its income tax return. For rules in the case of taxpayers filing consolidated returns, see § 1.1502–77(a) of this chapter (Income Tax Regulations). Such statement shall contain the following information:

(1) The name, address, and taxpayer identification number of the taxpayer,

(2) The paragraph (or paragraphs) of section 46(e) under which the taxpayer is making the election,

(3) If an election is made under the last sentence of section 46(e)(1), the name and address of all regulatory bodies which have jurisdiction over the taxpayer with respect to the section 46(e) property covered by such election and a statement setting forth the type of the public utility activity described in section 46(e)(5)(B) in which the taxpayer engages, and

(4) If an election is made under paragraph (3) of section 46(e), a statement indicating whether an election has been made by the taxpayer under section 167(l)(4)(A).

[T.D. 7161, 37 FR 3511, Feb. 17, 1972]

§ 12.4 Election of Class Life Asset Depreciation Range System (ADR).

(a) *Elections filed before February 1, 1972.* No election or tax return shall be filed which does not conform to section 109 of the Revenue Act of 1971 (Pub. L. 92–178, 85 Stat. 508). If a taxpayer has before February 1, 1972 filed an election and a tax return in accordance with § 1.167(a)–11 of this chapter (relating to depreciation allowances using the Asset Depreciation Range System published in the FEDERAL REGISTER for June 23, 1971), such election will be treated as an election under the Class Life Asset Depreciation Range System (ADR) as contained in section 109 of the Revenue Act of 1971 and the proposed amendments to § 1.167(a)–11 of this chapter published in the FEDERAL REGISTER for January 27, 1972, provided that the election conforms with the provisions of the Class Life Asset Depreciation Range System (ADR) contained in section 109 of the Revenue Act of 1971 and the amendments to the regulations as finally adopted. Such an election and the determination of tax liability on the tax return are subject to the terms and conditions of section 109 of the Revenue Act of 1971 and the final regulations prescribing the Class Life Asset Depreciation Range System (ADR). (For revocation of an election, see paragraph (c) of this section.) An election and tax return filed before February 1, 1972, which does not conform with the final regulations prescribing the Class Life Asset Depreciation Range System (ADR) is an invalid election unless corrected by an amended tax return and election filed no later than the time permitted by paragraph (c) of this section. If a valid election under § 1.167(a)–11 of this chapter is not filed for a taxable year, the taxpayer is required to file or amend his tax return

and determine tax liability for the taxable year without regard to § 1.167(a)–11 of this chapter.

(b) *Elections filed after January 31, 1972.* No election or tax return shall be filed which does not conform with section 109 of the Revenue Act of 1971. An election and tax return filed under § 1.167(a)–11 of this chapter after January 31, 1972, and before the final amendments to the regulations are published in the FEDERAL REGISTER, should be filed in accordance with section 109 of the Revenue Act of 1971 and the proposed amendments to § 1.167(a)–11 of this chapter relating to the Class Life Asset Depreciation Range System (ADR). Such election and the determination of tax liability on the tax return are subject to the terms and conditions of section 109 of the Revenue Act of 1971 and the final regulations prescribing the Class Life Asset Depreciation Range System (ADR). An election and tax return filed after January 31, 1972, which does not conform with the final regulations prescribing the Class Life Asset Depreciation Range System (ADR), is not a valid election unless corrected by an amended tax return and election filed no later than the time permitted by paragraph (c) of this section. (For revocation of election, see paragraph (c) of this section.) If a valid election under § 1.167(a)–11 of this chapter is not filed for a taxable year the taxpayer is required to file or amend his tax return and determine tax liability for the taxable year without regard to § 1.167(a)–11 of this chapter.

(c) *Special rule for election and revocation.* Notwithstanding the rules of § 1.167(a)–11 of this chapter, a taxpayer is permitted to make, amend or revoke an election under § 1.167(a)–11 of this chapter at any time before the latest of (1) the time the taxpayer files his first return for the taxable year of election, (2) 120 days after the final regulations prescribing the Class Life Asset Depreciation Range System (ADR) are published in the FEDERAL REGISTER, or (3) the time prescribed by law (including extensions thereof) for filing the return for the taxable year of election. The notification of amendment or revocation of an election shall be made by filing an amended tax return with the Internal Revenue Service Center with which the election was filed. The election should be filed in the manner specified in the Class Life Asset Depreciation Range System (ADR) regulations as finally prescribed.

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

Example (1). Taxpayer A filed an election under § 1.167(a)–11 before February 1, 1972. A elected to use the modified half-year convention by treating all assets as placed in service on the first day of the second quarter of the taxable year, excluded section 1250 property (as defined in section 1250(c)) and property used predominantly outside the United States from the election, and included ''subsidiary assets'' (as defined in § 1.167(a)–11(b)(5)(vii) of the proposed amendments to the regulations) in the election. A's election does not conform with the regulations under § 1.167(a)–11 as proposed to be amended. A should file an amended return and election within 120 days after the publication of the final Class Life Asset Depreciation Range System (ADR) regulations under § 1.167(a)–11. Such amended return and election must conform to the final amendments to the regulations. In the amended election, A must adopt one of the conventions permitted by the final amendments. Assuming the proposed amendments are finally adopted, A may exclude his subsidiary assets from the election provided the conditions of paragraph (b)(5)(vii) of § 1.167(a)–11 of the regulations, as proposed to be amended, are met, and A must include property used predominantly outside the United States in the election unless paragraph (b)(5)(iii), (v), or (vi) of § 1.167(a)–11, as proposed to be amended, permit the exclusion of the property. Generally, A must include section 1250 property in the election unless paragraph (b)(5)(vi) of § 1.167(a)–11, as proposed to be amended, permits the exclusion of the property.

Example (2). Taxpayer B filed an election to compute depreciation under § 1.167(a)–11 before February 1, 1972. B elected to use the half-year convention and has no assets used predominantly outside the United States. B excluded section 1250 property from the election and included his subsidiary assets in the election. Assume that the provisions of paragraph (b)(5)(vi) of § 1.167(a)–11, as proposed to be amended, apply and permit the exclusion of section 1250 property and that B does not elect to exclude subsidiary assets pursuant to paragraph (b)(5)(vii), as proposed to be amended. B has no assets which were excluded from the election under paragraph (b)(5)(v) of § 1.167(a)–11, as proposed to be amended. The election which was filed before February 1, 1972, will be treated as a valid

election under the Class Life Asset Depreciation Range System (ADR) as contained in the final amendments to the regulations, if it conforms with those amendments. B need not file an amended election provided his election conforms to the final regulations under §1.167(a)–11. However, B may file an amended election within 120 days after the final regulations under §1.167(a)–11 are published in the FEDERAL REGISTER in order to include section 1250 property, or to exclude subsidiary assets, or to make other changes, or to revoke the election.

[T.D. 7159, 37 FR 1469, Jan. 29, 1972]

§ 12.7 Election to be treated as a DISC.

(a) *Manner and time of election*—(1) *Manner*—(i) *In general.* A corporation can elect to be treated as a DISC under section 992(b) for a taxable year beginning after December 31, 1971. Except as provided in subdivision (ii) of this subparagraph, the election is made by the corporation filing Form 4876 with the service center with which it would file its income tax return if it were subject for such taxable year to all the taxes imposed by subtitle A of the Internal Revenue Code of 1954, and a copy of the completed Form 4876 with the Commissioner of Internal Revenue (attention: ACTS:A:AO), Washington, D.C. 20224. The form shall be signed by any person authorized to sign a corporation return under section 6062, and shall contain the information required by such form. Except as provided in paragraphs (b)(3) and (c) of this section, such election to be treated as a DISC shall be valid only if the consent of every person who is a shareholder of the corporation as of the beginning of the first taxable year for which such election is effective is on or attached to such Form 4876 when filed with the service center.

(ii) *Transitional rule for corporations electing during 1972.* If the first taxable year for which an election by a corporation to be treated as a DISC is a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election may be made either in the manner prescribed in subdivision (i) of this subparagraph or by filing, at the place prescribed in subdivision (i) of this subparagraph, a statement captioned ''Election to be Treated as a DISC''. Such statement of election shall be valid only if the consent of each shareholder is filed with the service center in the form, and at the time, prescribed in paragraph (b) of this section. Such statement shall be signed by any person authorized to sign a corporation return under section 6062 and shall include the name, address, and employer identification number (if known) of the corporation, the beginning date of the first taxable year for which the election is effective, the number of shares of stock of the corporation issued and outstanding as of the earlier of the beginning of the first taxable year for which the election is effective or the time the statement is filed, the number of shares held by each shareholder as of the earlier of such dates, and the date and place of incorporation. As a condition of the election being effective, a corporation which elects to become a DISC by filing a statement in accordance with this subdivision must furnish (to the service center with which the statement was filed) such additional information as is required by Form 4876 by March 31, 1973.

(2) *Time of making election*—(i) *In general.* In the case of a corporation making an election to be treated as a DISC for its first taxable year, such election shall be made within 90 days after the beginning of such taxable year. In the case of a corporation which makes an election to be treated as a DISC for any taxable year beginning after March 31, 1972 (other than the first taxable year of such corporation), the election shall be made during the 90-day period immediately preceding the first day of such taxable year.

(ii) *Transitional rules for certain corporations electing during 1972.* In the case of a corporation which makes an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before March 31, 1972 (other than its first taxable year), the election shall be made within 90 days after the beginning of such taxable year.

(b) *Consent by shareholders*—(1) *In general*—(i) *Time and manner of consent.* Under paragraph (a)(1)(i) of this section, subject to certain exceptions, the election to be treated as a DISC is not valid unless each person who is a shareholder as of the beginning of the first taxable year for which the election is

effective signs either the statement of consent on Form 4876 or a separate statement of consent attached to such form. A shareholder's consent is binding on such shareholder and all transferees of his shares and may not be withdrawn after a valid election is made by the corporation. In the case of a corporation which files an election to become a DISC for a taxable year beginning after December 31, 1972, if a person who is a shareholder as of the beginning of the first taxable year for which the election is effective does not consent by signing the statement of consent set forth on Form 4876, such election shall be valid (except in the case of an extension of the time for filing granted under the provisions of subparagraph (3) of this paragraph or paragraph (c) of this section) only if the consent of such shareholder is attached to the Form 4876 upon which such election is made.

(ii) *Form of consent.* A consent other than the statement of consent set forth on Form 4876 shall be in the form of a statement which is signed by the shareholder and which sets forth *(a)* the name and address of the corporation and of the shareholder and *(b)* the number of shares held by each such shareholder as of the time the consent is made and (if the consent is made after the beginning of the corporation's taxable year for which the election is effective) as of the beginning of such year. If the consent is made by a recipient of transferred shares pursuant to paragraph (c) of this section, the statement of consent shall also set forth the name and address of the person who held such shares as of the beginning of such taxable year and the number of such shares. Consent shall be made in the following form: ''I (insert name of shareholder), a shareholder of (insert name of corporation seeking to make the election) consent to the election of (insert name of corporation seeking to make the election) to be treated as a DISC under section 992(b) of the Internal Revenue Code. The consent so made by me is irrevocable and is binding upon all transferees of my shares in (insert name of corporation seeking to make the election).'' The consents of all shareholders may be incorporated in one statement.

(iii) *Who may consent.* Where stock of the corporation is owned by a husband and wife as community property (or the income from such stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in such stock or the income therefrom and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. The consent of a minor shall be made by his legal guardian or by his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The consent of a trust shall be made by the trustee thereof. The consent of an estate or trust having more than one executor, administrator, or trustee may be made by any executor, administrator, or trustee authorized to make a return of such estate or trust pursuant to section 6012(b)(5). The consent of a corporation or partnership shall be made by an officer or partner authorized pursuant to section 6062 or 6063, as the case may be, to sign the return of such corporation or partnership. In the case of a foreign person, the consent may be signed by any individual (whether or not a U.S. person) who would be authorized under sections 6061 through 6063 to sign the return of such foreign person if he were a U.S. person.

(2) *Transitional rule for corporations electing during 1972.* In the case of a corporation which files an election to be treated as a DISC for a taxable year beginning after December 31, 1971, and on or before December 31, 1972, such election shall be valid only if the consent of each person who is a shareholder as of the beginning of the first taxable year for which such election is effective is filed with the service center with which the election was filed within 90 days after the first day of such taxable year or within the time granted for an extension of time for filing such consent. The form of such consent shall be the same as that prescribed in subparagraph (1) of this paragraph. Such consent shall be attached to the statement of election or shall be filed separately (with such service center) with a copy of the statement of election. An extension of time for filing a

consent may be granted in the manner, and subject to the conditions, described in subparagraph (3) of this paragraph.

(3) *Extension of time to consent.* An election which is timely filed and would be valid except for the failure to attach the consent of any shareholder to the Form 4876 upon which the election was made or to comply with the 90-day requirement in subparagraph (2) of this paragraph or paragraph (c)(1) of this section, as the case may be, will not be invalid for such reason if it is shown to the satisfaction of the service center that there was a reasonable cause for the failure to file such consent, and if such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service. In the case of a late filing of a consent, a copy of the Form 4876 or statement of election shall be attached to such consent and shall be filed with the same service center as the election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. In no event can any consent be made pursuant to this paragraph on or after the last day of the first taxable year for which a corporation elects to be treated as a DISC.

(c) *Consent by holder of transferred shares*—(1) *In general.* If a shareholder of a corporation transfers—

(i) Prior to the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him without having consented to such election, or

(ii) On or before the 90th day after the first day of the first taxable year for which such corporation elects to be treated as a DISC, some or all of the shares held by him as of the first day of such year (or if later, held by him as of the time such shares are issued), without having consented to such election, then consent may be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, an extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of this section. In addition, if the transfer occurs more than 90 days after the first day of such taxable year, an extension of time for filing such consent may be granted to such recipient only if it is determined under paragraph (b)(3) of this section that an extension of time would have been granted the transferor for the filing of such consent if the transfer had not occurred. A consent which is not attached to the original Form 4876 or statement of election (as the case may be) shall be filed with the same service center as the original Form 4876 or statement of election and shall have attached a copy of such original form or statement of election. The form of such consent shall be the same as that set forth in paragraph (b)(1)(ii) of this section. For the purposes of this paragraph, a transfer of shares includes any sale, exchange, or other disposition, including a transfer by gift or at death.

(2) *Requirement for the filing of an amended form 4876 or statement of election.* In any case in which a consent to a corporation's election to be treated as a DISC is made pursuant to subparagraph (1) of this paragraph, such corporation must file an amended form 4876 or statement of election (as the case may be) reflecting all changes in ownership of shares. Such form must be filed with the same service center with which the original form 4876 or statement of election was filed by such corporation.

(d) *Effect of election*—(1) *Effect on corporation.* A valid election to be treated as a DISC remains in effect (without regard to whether the electing corporation qualifies as a DISC for a particular year) until terminated by any of the methods provided in paragraph (e) of this section. While such election is in effect, the electing corporation is subject to sections 991 through 997 and other provisions of the code applicable to DISC's for any taxable year for which it qualifies as a DISC (or is treated as qualifying as a DISC pursuant to section 992(a)(2)). Such corporation is also subject to such provisions for any taxable year for which it is treated as a former DISC as a result of qualifying or being treated as a DISC for any taxable year for which such election was in effect.

(2) *Effect on shareholders.* A valid election by a corporation to be treated as a DISC subjects the shareholders of such corporation to the provisions of section 995 (relating to the taxation of the shareholders of a DISC or former DISC) and to all other provisions of the code relating to the shareholders of a DISC or former DISC. Such provisions of the code apply to any person who is a shareholder of a DISC or former DISC whether or not such person was a shareholder at the time the corporation elected to become a DISC.

(e) *Termination of election*—(1) *In general.* An election to be treated as a DISC is terminated only as provided in subparagraph (2) or (3) of this paragraph.

(2) *Revocation of election*—(i) *Manner of revocation.* An election by a corporation to be treated as a DISC may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. Such revocation shall be made by the corporation filing a statement that the corporation revokes its election under section 992(b) to be treated as a DISC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporation return under section 6062. Such revocation shall be filed with the service center with which the corporation filed its election, except that, if it filed an annual information return under section 6011(e)(2), the revocation shall be filed with the service center with which it filed its last such return.

(ii) *Years for which revocation is effective.* If a corporation files a statement revoking its election to be treated as a DISC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a DISC after the first 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

(3) *Continued failure to be a DISC.* If a corporation which has elected to be treated as a DISC does not qualify as a DISC (and is not treated as a DISC pursuant to section 992(a)(2)) for each of any 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such 5th taxable year. Such termination will be effective automatically, without notice to such corporation or to the Internal Revenue Service. If, during any 5-year period for which an election is effective, the corporation should qualify as a DISC (or be treated as a DISC pursuant to section 992(a)(2)) for a taxable year, a new 5-year period shall automatically start at the beginning of the following taxable year.

(4) *Election after termination.* If a corporation has made a valid election to be treated as a DISC and such election terminates in either manner described in subparagraph (2) or (3) of this paragraph, such corporation is eligible to reelect to be treated as a DISC at any time by following the procedures described in paragraphs (a) through (c) of this section. If a corporation terminates its election and subsequently reelects to be treated as a DISC, the corporation and its shareholders continue to be subject to sections 995 and 996 with respect to the period during which its first election was in effect. Thus, for example, distributions upon disqualification includible in the gross incomes of shareholders of a corporation pursuant to section 995(b)(2) continue to be so includible for taxable years for which a second election of such corporation is in effect without regard to the second election.

[T.D. 7237, 37 FR 28626, Dec. 28, 1972]

§ 12.8 Elections with respect to net leases of real property.

(a) *In general.* The elections described in this section are available for determining whether real property held by the taxpayer is subject to a net lease for purposes of section 57 (relating to items of tax preference for purposes of the minimum tax for tax preferences) or 163(d) (relating to limitation on interest on investment indebtedness). Under sections 57(c)(1)(A) and 163(d)(4)(A)(i), property will be considered to be subject to a net lease for a

taxable year where the sum of the deductions of the lessor with respect to the property for the taxable year allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to the property) is less than 15 percent of the gross income from rents produced by the property (hereinafter referred to as the ''expense test''). Under sections 57(c)(2) and 163(d)(7)(A), where a parcel of real property of the taxpayer is leased under two or more leases, the taxpayer may elect to apply the expense test set forth in sections 57(c)(1)(A) and 163(d)(4)(A)(i) by treating all leased portions of such property as subject to a single lease. Under sections 57(c)(3) and 163(d)(7)(B), at the election of the taxpayer, the expense test set forth in sections 57(c)(1)(A) and 163(d)(4)(A)(i) shall not apply with respect to real property of the taxpayer which has been in use for more than 5 years.

(b) *Election with respect to multiple leases of single parcel of real property.* If a parcel of real property of the taxpayer is leased under two or more leases, the expense test referred to in paragraph (a) of this section shall, at the election of the taxpayer, be applied by treating all leased portions of such property as subject to a single lease. For purposes of this paragraph, the term ''parcel of real property'' includes adjacent properties each of which is subject to lease.

(c) *Election with respect to real property in use for more than 5 years.* At the election of the taxpayer, the expense test referred to in paragraph (a) of this section shall not apply with respect to real property of the taxpayer which has been in use for more than 5 years. For this purpose, real property is in use only during the period that such property is both owned and used for commercial purposes by the taxpayer. If an improvement to the property was made during the time such property was owned by the taxpayer, and if, as a result of such improvement, the adjusted basis of such property was increased by 50 percent or more, use of such property for commercial purposes shall be deemed to have commenced for purposes of this paragraph as of the date such improvement was completed. An election under this paragraph shall apply to all real property of the taxpayer which has been in use for more than 5 years.

(d) *Procedure for making election*— (1) *Time and scope of election.* An election under paragraph (b) or (c) of this section shall be made for each taxable year to which such election is to apply. The election must be made before the later of (i) the time prescribed by law for filing the taxpayer's return for the taxable year for which the election is made (determined with regard to any extension of time) or (ii) August 31, 1973, but the election may not be made after the expiration of the time prescribed by law for the filing of a claim for credit or refund of tax with respect to the taxable year for which the election is to apply.

(2) *Manner of making election.* Except as provided in the following sentence, an election by the taxpayer with respect to a taxable year shall be made by a statement containing the information described in paragraph (d)(3) of this section which is—

(i) Attached to the taxpayer's return or amended return for such taxable year,

(ii) Attached to a timely filed claim by the taxpayer for credit or refund of tax for such taxable year, or

(iii) Filed by the taxpayer with the director of the Internal Revenue Service Center where the return for such taxable year was filed.

In the case of a taxable year ending before July 1, 1973, no formal statement of election is necessary if the taxpayer's return took into account an election under paragraph (b) or (c) of this section; the taxpayer will be considered to have made an election in accordance with the manner in which leases with respect to parcels of real property described in paragraph (b) of this section, or leases of property which has been in use for more than 5 years as described in paragraph (c) of this section, are treated in the return.

(3) *Statement.* The statement described in paragraph (d)(2) of this section shall contain the following information:

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

(ii) The taxable year to which the election is to apply if the statement is

not attached to the return or a claim for credit or refund;

(iii) A description of any leases which are to be treated as a single lease; and

(iv) A description of any real property in use for more than 5 years to which the expense test is not to apply.

(4) *Revocation of election.* An election made pursuant to this paragraph may be revoked within the time prescribed in paragraph (d)(1) of this section for making an election and may not be revoked thereafter. Any such revocation shall be made in the manner prescribed by paragraph (d)(2) of this section for the making of an election.

(e) *Election by members of partnership.* Under section 703(b) (as amended by section 304(c) of the Revenue Act of 1971), any election under section 57(c) or 163(d)(7) with respect to property held by a partnership shall be made by each partner separately, rather than by the partnership. If an election made by a taxpayer under paragraph (b) of this section applies in whole or in part to property held by a partnership, the taxpayer shall, in applying the expense test referred to in paragraph (a) of this section, take into account his distributive share of the deductions of the partnership with respect to the property for the taxable year allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to the property) and also his distributive share of the partnership's rental income from such property for the taxable year.

[T.D. 7271, 38 FR 9296, Apr. 13, 1973]

§ 12.9 Election to postpone determination with respect to the presumption described in section 183(d).

(a) *In general.* An individual, electing small business corporation, trust or estate may elect in accordance with the rules set forth in this section to postpone a determination whether the presumption described in section 183(d) applies with respect to any activity in which the taxpayer engages until after the close of the fourth taxable year (sixth taxable year, in the case of an activity described in § 1.183–1(c)(3)) following the taxable year in which the taxpayer first engages in such activity. The election must be made in accordance with the applicable requirements of paragraphs (b), (c) and (d) of this section. Except as otherwise provided in paragraphs (c) and (e) of this section, an election made pursuant to this section shall be binding for the first taxable year in which the taxpayer first engages in the activity and for all subsequent taxable years in the five (or seven) year period referred to in the first sentence of this paragraph. For purposes of this section, a taxpayer shall be treated as not having engaged in an activity during any taxable year beginning before January 1, 1970.

(b) *Period to which an election applies.* An individual, trust, estate, or small business corporation may make the election. The five year presumption period (seven year presumption period in the case of an activity described in § 1.183–1(c)(3)) to which the election shall apply shall be the five (or seven) consecutive taxable years of such taxpayer beginning with the taxable year in which such taxpayer first engages in the activity. For purposes of this section, a taxpayer who engages in an activity as a partner, engages in it in each of his taxable years with or within which ends a partnership year during which the activity was carried on by the partnership.

(c) *Time for making an election.* A taxpayer who is an individual, trust, estate or small business corporation may make the election provided in § 183(e) by filing the statement and consents required by paragraph (d) of this section within—

(1) 3 years after the due date of such taxpayer's return (determined without extensions) for the taxable year in which such taxpayer first engages in the activity, but not later than

(2) 60 days after such taxpayer receives a written notice (if any) from a district director that the district director proposes to disallow deductions attributable to an activity not engaged in for profit under section 183.

The provisions of paragraph (c)(2) of this section shall in no event be construed to extend the period described in (c)(1) of this section for making such election. Notwithstanding the time periods prescribed in paragraph (c) (1) and (2) of this section, if no election has been made before a suit or proceeding

described in section 7422(a) is maintained or a petition is filed in the Tax Court for a redetermination of a deficiency for any taxable year within the presumption period to which the election would apply, no election may be made except with the consent of the Commissioner which will not be given unless no appreciable delay in the suit or proceeding will be caused.

(d) *Manner of making election.* (1) The election shall be made by the individual, trust, estate, or electing small business corporation, as the case may be, engaged in the activity, by filing a statement which sets forth the following information—

(i) The name, address, and taxpayer identification number of such taxpayer, and, if applicable, of the partnership in which he engages in the activity,

(ii) A declaration stating that the taxpayer elects to postpone a determination as to whether the presumption described in section 183(d) applies until after the close of the taxpayer's fourth taxable year (sixth taxable year, in the case of an activity described in § 1.183–1(c)(3)) following the taxable year in which the taxpayer first engaged in such activity and identifying that first such taxable year, and,

(iii) A description of each activity (as defined in § 1.183–1(d)(1)) with respect to which the election is being made.

(2) For an election to be effective, there must be attached to the statement properly executed consents, in the form prescribed by the Commissioner, extending the period prescribed by section 6501 for the assessment of any tax to a date which is not earlier than 18 months after the due date of the return (determined without extensions) for the final year in the presumption period to which the election applies, as follows:

(i) Consents for each of the taxpayer's taxable years in the presumption period to which the election applies,

(ii) If the election is made by an electing small business corporation, a consent of each person who is a shareholder during any taxable year to which the election applies, for each of such shareholder's taxable years with or within which end each of the corporation's taxable years in the presumption period,

(iii) If a taxpayer referred to in paragraph (d)(2)(i) of this section or shareholder referred to in paragraph (d)(2)(ii) of this section is married at the time of the election, in the case of his present spouse, a consent for each of such spouse's taxable years which correspond to the taxable years (other than prior years of the shareholder during no part of which he was a shareholder) for which consents are required by paragraph (d)(2) (i) or (ii) of this section as the case may be.

Such consents shall not be construed to shorten the period described in section 6501 for any taxable year within the presumption period to which the election applies.

(3) The statement, with the required consents attached, shall be filed—

(i) With the service center at which the taxpayer making the election is required to file his return, or

(ii) If the taxpayer is notified by a district director that, pursuant to section 183 he is proposing to disallow deductions with respect to an activity not engaged in for profit, with such district director.

(e) *Subsequent invalidations.* If, after a timely election has been made, but still within the presumption period, a suit or proceeding (as described in section 7422(a)) is maintained by the electing taxpayer, a shareholder referred to in paragraph (d)(2)(ii) of this section, or spouse referred to in paragraph (d)(2)(iii) of this section for any taxable year for which a consent is required by this section and the taxpayer, shareholder, or spouse has not been issued a notice of deficiency (as described in section 6212(a)) with respect to such taxable year, such election shall not be effective to postpone the determination whether the presumption applies, for such taxable year, but the consents extending the statute of limitations filed with the election shall not thereby be invalidated. The immediately preceding sentence shall not apply to a suit or proceeding maintained by the spouse of an electing taxpayer for a taxable year for which such spouse has filed a separate return, or a suit or proceeding maintained by a shareholder for a taxable year in which he was not

such a shareholder. An election by an individual taxpayer or electing small business corporation, shall be subsequently invalidated for all years in the presumption period to which it had applied if—

(1) The electing taxpayer or shareholder taxpayer files a joint return for one of the first three (five, in the case of an activity described in § 1.183–1(c)(3)) taxable years in such presumption period, and

(2) The spouse with whom he files such joint return has not previously executed a consent described in paragraph (d)(2)(iii) of this section, and

(3) Within one year after the filing of such joint return (or, if later, 90 days after March 14, 1974), such spouse has not filed a consent described in paragraph (d)(2) of this section.

An election by an electing small business corporation shall be invalidated for all years in the presumption period to which it applies if a person who was not a shareholder on the date of election becomes a shareholder during the first three (or five) years of the presumption period to which the election applies and does not, within 90 days after the date on which he becomes a shareholder (or, if later, 90 days after March 14, 1974), file a consent required by paragraph (d)(2) of this section. Invalidation of the election by operation of this paragraph will in no case affect the validity of the consents filed with such election.

(f) *Extension of time for filing election in hardship cases.* The Commissioner may upon application by a taxpayer, consent to an extension of time prescribed in this section for making an election if he finds that such an extension would be justified by hardship incurred by reason of the time at which this section is published. The burden will be on the taxpayer to establish that under the relevant facts the Commissioner should so consent.

[T.D. 7308, 39 FR 9947, Mar. 15, 1974]

PART 13—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1969

Sec.

13.0—13.3 [Reserved]
13.4 Arbitrage bonds; temporary rules.
13.5—13.9 [Reserved]
13.10 Distribution of money in lieu of fractional shares.
13.11 Revocation of election to report income on the installment basis.

AUTHORITY: 26 U.S.C. 7805.

§§ 13.0—13.3 [Reserved]

§ 13.4 Arbitrage bonds; temporary rules.

(a) *In general*—(1) *Arbitrage bonds.* Section 103(d)(1) provides that any arbitrage bond (as such term is defined in section 103(d)(2)) shall be treated as an obligation not described in section 103(a)(1). Thus, the interest on an obligation which would have been excluded from gross income pursuant to the provisions of section 103(a)(1) will be included in gross income and subject to Federal income taxation if such obligation is an arbitrage bond. Under section 103(d)(2), an obligation is an arbitrage bond if it is issued by a governmental unit as part of an issue of obligations (for purposes of this section referred to as ''governmental obligations'') all or a major portion of the proceeds of which are (i) reasonably expected to be used directly or indirectly to acquire certain obligations or securities (for purposes of this section referred to as ''acquired obligations'') which may reasonably be expected, at the time of issuance of such governmental obligations, to produce a yield over the term of the issue of such governmental obligations which is materially higher (taking into account any discount or premium) than the yield on such issue, or (ii) reasonably expected to be used to replace funds which were used directly or indirectly to acquire such acquired obligations. For rules as to industrial development bonds, see section 103(c).

(2) *Definitions.* (i) For purposes of this section, the term ''governmental unit'' means a State, the District of Columbia, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing.

(ii) For purposes of this section, the term ''securities'' has the same meaning as in section 165(g)(2) (A) and (B).

(3) *Materially higher.* For purposes of this section, the yield produced by acquired obligations is not ''materially

higher'' than the yield produced by an issue of governmental obligations if it is reasonably expected, at the time of issue of such governmental obligations, that the adjusted yield (computed in accordance with subparagraphs (4) and (5) of this paragraph) to be produced by the acquired obligations will not exceed the adjusted yield (computed in accordance with subparagraphs (4) and (5) of this paragraph) to be produced by the issue of governmental obligations by more than one-eighth of 1 percentage point. In the case of an issue of governmental obligations issued on or before July 1, 1972, the percentage specified in the preceding sentence shall be one-half of 1 percentage point.

(4) *Yield.* (i) For purposes of this section, ''yield'' shall be computed using the ''interest cost per annum'' method in accordance with subdivision (ii) or (iii) of this subparagraph (as the case may be) or any other method satisfactory to the Commissioner which is consistent with generally accepted principles of computing yield. In the case of acquired obligations, the yield to be produced by such obligations shall be computed as if all acquired obligations comprised a single issue of obligations. Thus, for example, if the governmental unit acquires two blocks of Federal obligations, with different interest rates and maturity periods for each block, the yield on such acquired obligations shall be computed as if one issue of obligations with different interest rates and maturity periods had been acquired. The maturity period of each acquired obligation shall be the period that the governmental unit reasonably expects to hold such obligation.

(ii) If all the governmental or acquired obligations of an issue have a single interest rate (expressed in dollars per $1,000 of face amount of bonds), yield shall be computed using the following 4 steps:

(a) Step (1). Compute the total number of bond years for the issue by multiplying the number of bonds (treating each $1,000 of face value as one bond for purposes of this computation) of each maturity by the length of the maturity period (expressed in years and fractions thereof) and then adding together the amounts determined for each maturity period.

(b) Step (2). Compute the total interest payable on the issue by multiplying the total number of bond years (as computed in step (1)) by the amount payable, expressed in dollars, as interest on each $1,000 of bonds for 1 year.

(c) Step (3). Compute the net interest in dollars for the issue by adding the amount, in dollars, of any discount to, or by subtracting the amount, in dollars, of any premium from, the total interest payable on the issue.

(d) Step (4). Compute yield by dividing the net interest by the product obtained by multiplying the total number of bond years for the issue by 10.

(iii) If governmental or acquired obligations of an issue have different interest rates (expressed in dollars per $1,000 of face amount of bonds), yield shall be computed using the following 4 steps:

(a) Step (1). Compute the total number of bond years for each group of bonds bearing the same interest rate (treating each $1,000 of face value as one bond for purposes of this computation) in the manner described in step 1 of subdivision (ii) of this subparagraph.

(b) Step (2). Compute the total interest payable on the issue by multiplying the total number of bond years for each group of bonds bearing the same interest rate (as computed in step (1)) by the amount payable, expressed in dollars, as interest on each $1,000 of bonds for 1 year, and then adding together the amounts determined for each group.

(c) Step (3). Compute net interest in the manner described in step (3) of subdivision (ii) of this subparagraph.

(d) Step (4). Compute the yield produced by the issue in the manner described in step (4) of subdivision (ii) of this subparagraph.

(iv) For purposes of this section, the same method of computing yield shall be used to compute the yield to be produced by an issue of governmental obligations and to compute the yield to be produced by acquired obligations acquired with the proceeds of such issue of governmental obligations.

(v) The following example illustrates the provisions of this subparagraph:

Example. Assume an issue of $200,000 ($1,000 per bond) with a stated interest (expressed in dollars per bond) of $50 on bonds maturing in 1, 2, or 3 years, a stated interest of $60 on bonds maturing in 4, 5, 6, or 7 years and a

stated interest of $70 on bonds maturing in 8, 9, or 10 years. Assume also that a price of $101 has been bid for the issue. The yield on the issue is determined in accordance with the table below:

	Amount	Rate	Years to maturity	Bond years	Total bond years at interest rate	×	Interest rate	=	Interest cost
	$10,000	$50	1						
	5,000	50	2						
	25,000	50	3						
					95				$4,750
	10,000	60	4	40					
	10,000	60	5	50					
	30,000	60	6	180					
	50,000	60	7	350					
					620				37,200
	20,000	70	8	160					
	25,000	70	9	225					
	15,000	70	10	150					
					535		70		37,450
Totals	200,000				1,250				79,400
Less premium									2,000
Net interest cost									77,400
Divide by: Product of total bond years (1,250), multiplied by 10									12,500
Yield (Percent)									6,192

(5) *Adjusted yield.* (i) For purposes of this section, ''adjusted yield'' shall be computed in accordance with subparagraph (4) of this paragraph, except that in the case of—

(a) Acquired obligations, an amount equal to the sum of the administrative costs reasonably expected to be incurred in purchasing, carrying, and selling or redeeming such obligations shall be treated as a premium on the purchase price of such acquired obligations.

(b) An issue of governmental obligations, an amount equal to the sum of the reasonably expected administrative costs of issuing, carrying, and repaying such issue of obligations shall be treated as a discount on the selling price of such issue of governmental obligations.

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

Example (1). State Z issues $15 million of obligations all of which will mature in 10 years. The obligations are sold at $1,000 each (par) to yield 6 percent interest. The adjusted yield produced by such issue of obligations will be determined as follows, assuming the following administrative expenses of issuing, carrying, and repaying such issue of obligations are reasonably expected:

Issuing costs:		
Printing	$12,500	
Financial advisors	25,000	
Counsel fees	12,500	
Total		$50,000
Carrying costs, paying agent and trustees fees		10,000
Repaying costs, paying agent		3,000
Total administrative costs		63,000
Bond years (15,000×10 years)		150,000
Interest cost per $1,000 bond per year		60
Total interest cost		9,000,000
Discount or premium		0
Plus adjustments		63,000
Net interest cost		9,063,000
Divide by product of bond years (150,000) multiplied by 10		1,500,000
Adjusted yield		6.042%

Example (2). State Z uses the net proceeds of the issue of obligations described in Example (1) to acquire $14,922,000 of student's notes at par of $1,000 each under a student loan program. The students' notes will all mature in 10 years, and all have a stated interest of 7½ percent. Expenses of the program including printing of forms ($5,000), financial advisors' fees ($11,000), counsel fees ($12,000), trustees' fees ($5,000), fees for the collecting agents and various banks which

administer the loans ($100,000), advertising expenses ($10,000), credit reference checks ($20,000), and general office overhead ($5,000). Of the expenses listed in the preceding sentence, only those indicated on the following table constitute adjustments to yield in order to determine the adjusted yield to be produced by the students' notes:

Purchasing costs:		
Printing forms	$5,000	
Financial advisors	11,000	
Counsel fees	12,000	
Total		$28,000
Carrying costs, trustees fees		5,000
Total administrative costs		33,000
Bond years (14,922×10 years)		149,220
Interest receivable per $1,000 note per year		75
Total interest receivable		11,191,500
Discount or premium		0
Minus adjustments		33,000
Net interest receivable		11,158,500
Divide by product of bond years (149,220) multiplied by 10		1,492,200
Adjusted yield		7.478%

(b) *Rule with respect to certain governmental programs*—(1) *General rule.* Subject to the limitations of subparagraph (3) of this paragraph, any obligations which are part of an issue of governmental obligations the proceeds of which are reasonably expected to be used to finance certain governmental programs (described in subparagraph (2) of this paragraph) are not arbitrage obligations.

(2) *Governmental programs.* A governmental program is described in this subparagraph if—

(i) The program involves the acquisition of acquired purpose obligations to carry out the purposes of such program (which obligations, for purposes of this paragraph, are referred to as ''acquired program obligations'');

(ii) At least 90 percent of all such acquired program obligations, by amount of cost outstanding, are evidences of loans to a substantial number of persons representing the general public, loans to exempt persons within the meaning of section 103(c)(3), or loans to provide housing and related facilities, or any combination of the foregoing;

(iii) At least 90 percent of all of the amounts received by the governmental unit with respect to acquired program obligations shall be used for one or more of the following purposes: To pay the principal or interest or otherwise to service the debt on governmental obligations relating to the governmental program; to reimburse the governmental unit, or to pay, for administrative costs of issuing such governmental obligations; to reimburse the governmental unit, or to pay, for administrative and other costs and anticipated future losses directly related to the program financed by such governmental obligations; to make additional loans for the same general purposes specified in such programs; or to redeem and retire governmental obligations at the next earliest possible date of redemption; and

(iv) Requires that any person (or any related person, as defined in section 103(c)(6)(C)) from whom the governmental unit may, under the program, acquire acquired program obligations shall not, pursuant to an arrangement, formal or informal, purchase the governmental obligations in an acquired program obligations to be acquired from such person by the governmental unit.

(3) *Limitation.* The provisions of subparagraph (1) of this paragraph shall apply only if it is reasonably expected that—

(i) A major portion of the proceeds of such issue of governmental obligations, including proceeds represented by repayments of principal and interest received by the governmental unit with respect to acquired program obligations, shall not be invested for more than a temporary period (within the meaning of section 103(d)(4)(A)), in acquired obligations (other than acquired program obligations) which produce a materially higher yield than the yield produced over the term of the issue by such governmental obligations, and

(ii)*(a)* The adjusted yield (computed in accordance with paragraphs (a) (4) and (5) of this section) to be produced by acquired program obligations shall not exceed the adjusted yield (computed in accordance with paragraphs (a) (4) and (5) of this section) to be produced by such issue of governmental obligations by more than 1½ percentage points, or

(b) Where the difference in the adjusted yields described in subdivision (ii)*(a)* of this subparagraph is expected

to exceed 1½ percentage points, the amounts to be obtained as a result of the difference in such adjusted yields shall not exceed the amount necessary to pay expenses (including losses resulting from bad debts) reasonably expected to be incurred as a direct result of administering the program to be financed with the proceeds of such issue of governmental obligations, to the extent that such amounts are not payable with funds appropriated from other sources.

(4) *Examples.* The following examples illustrate governmental programs described in subparagraph (2) of this paragraph:

Example (1). State A issues obligations the proceeds of which are to be used to purchase certain home mortgage notes from commercial banks. The purpose of the governmental program is to encourage the construction of low income residential housing by creating a secondary market for mortgage notes and thereby increasing the availability of mortgage money for low income housing. The legislation provides that the adjusted yield produced by the mortgage notes to be acquired will not exceed the adjusted yield produced by such issue of obligations by more than 1½ percentage points. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To service the debt on the governmental obligations, (2) to retire such obligations at their earliest possible date of redemption, (3) to purchase additional mortgage notes. The governmental program is one which is described in subparagraph (2) of this paragraph and the governmental obligations are not arbitrage bonds.

Example (2). State B issues obligations the proceeds of which are to be used to make loans directly to students and to purchase from commercial banks promissory notes made by students as the result of loans made to them by such banks. The legislation authorizing the student loan program provides that the purpose of the program is to enable financially disadvantaged students to continue their studies. The legislation also provides that purchases will be made from banks only where such banks agree that an amount at least equal to the purchase price will be devoted to new or additional student loans. It is reasonably expected that the difference in adjusted yields between the issue of governmental obligations by State B and the students' notes will be 1¾ percentage points. It is also reasonably expected that the amount necessary to pay the expenses (other than expenses taken into account in computing adjusted yield) enumerated in subparagraph (3)(ii)*(b)* of this paragraph, directly incurred as a result of administering State B's student loan program, such as, for example, losses resulting from bad debts, insurance costs, bookkeeping expenses, advertising expenses, credit reference checks, appraisals, title searches, general office overhead, service fees for collecting agents and various banks which administer the loans, and salaries of employees not paid from other sources, will not require a difference in adjusted yields in excess of 1½ percentage points. The governmental program is one which is described in subparagraph (2) of this paragraph. Since, however, the difference in adjusted yields produced by the students' notes and the issue of State B obligations is reasonably expected to exceed 1½ percentage points, and since State B cannot show that 1¾ percentage points is necessary to cover such expenses, the provisions of subparagraph (1) of this paragraph shall not apply to the issue of State B obligations. If, however, State B reasonably expected that 1¾ percentage points would be necessary to cover such expenses, the provisions of subparagraph (1) of this paragraph would apply and the governmental obligations would not be arbitrage bonds.

Example (3). Authority C issues obligations the proceeds of which are to be used to purchase land to be sold to veterans. The governmental unit will receive purchase-money mortgage notes secured by mortgages on the land from the veterans in return for such land. The purpose of the program is to enable veterans to acquire land at reduced cost. The adjusted yield produced by the mortgage notes is not reasonably expected to exceed the adjusted yield produced by the issue of obligations issued by Authority C by more than 1½ percentage points. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) To pay the administrative costs directly related to the program, (2) to service the debt on the governmental obligations, (3) to retire such governmental obligations at their earliest possible call date, (4) to purchase additional land to be sold to veterans. The governmental program is one which is described in subparagraph (2) of this paragraph and the governmental obligations are not arbitrage bonds.

(c) *Effective date.* The provisions of this section will apply with respect to obligations issued after October 9, 1969, and before final regulations are promulgated.

[T.D. 7072, 35 FR 17406, Nov. 13, 1970; 35 FR 18524, Dec. 5, 1970, as amended by T.D. 7174, 37 FR 10932, June 1, 1972; T.D. 7273, 38 FR 10927, May 3, 1973]

§§13.5—13.9 [Reserved]

§13.10 Distribution of money in lieu of fractional shares.

(a) *In general.* (1) Under the general rule of section 305, as amended by section 421(a) of the Tax Reform Act of 1969, gross income does not include the amount of any distribution of the stock (or rights to acquire the stock) of a corporation made by such corporation to its shareholders with respect to its stock. Under an exception to the general rule, a distribution by a corporation of its stock or rights to acquire its stock is treated as a distribution of property to which section 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of (i) the receipt of money or other property by some shareholders, and (ii) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Also, the Secretary or his delegate is directed to prescribe regulations under which a redemption which is treated as a distribution to which section 301 applies, or any other transaction having a similar effect on the interest of any shareholder, shall be treated as a distribution with respect to any shareholder whose proportionate interest in the assets or earnings and profits of the corporation is increased by such redemption or transaction.

(2) The general rule, and not the exception, applies in the case where cash is distributed in lieu of fractional shares to which the shareholders would otherwise be entitled, provided the purpose in distributing the cash is to save the distributing corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation.

(b) *Illustration.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. Corporation X is a large corporation whose stock is widely held by the public, no one shareholder owning more than 10 percent of the outstanding stock. The stock is listed on a recognized exchange and is currently selling at less than $75 per share. During the year the corporation pays a 3-percent stock dividend. Cash is paid to each shareholder in lieu of a fractional share to which he would otherwise be entitled. The distribution of cash in lieu of fractional shares is not intended to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation, but is intended to save the corporation the trouble, expense, and inconvenience of issuing and transferring scrip representing fractional shares. The general rule, and not the exception, applies in this situation.

(Sec. 305(c), 83 Stat. 614; 26 U.S.C. 305(c))

[T.D. 7039, 35 FR 7012, May 2, 1970]

§13.11 Revocation of election to report income on the installment basis.

(a) *In general.* Under section 453(c)(4) taxpayers who are dealers in personal property and who elected installment-basis income reporting, subject to the provisions of section 453(c)(1) (relating to change from accrual to installment basis), may revoke their previously made election.

(b) *Time and manner of revoking election.* The revocation by a taxpayer may be made by filing an amended return on an appropriate form or forms, such as Form 1040X for an individual taxpayer, for the year of change (the first year for which income was computed using the installment basis) and for each subsequent year for which a return was filed using the installment basis. The taxpayer should indicate on such amended returns that he is revoking an election to report income on the installment basis. Such revocation must be made within 3 years from the last date prescribed for the filing of the return for the year of change including any extension of time granted the taxpayer. In reporting income on the amended returns described in this section, the taxpayer shall use the accrual method of accounting.

[T.D. 7044, 35 FR 8823, June 6, 1970]

PART 14a—TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS

AUTHORITY: 26 U.S.C. 7805.

§ 14a.422A–1 Questions and answers relating to incentive stock option transitional rules.

The following questions and answers relate to the application of incentive stock option (ISO) treatment to certain previously granted stock options, pursuant to section 422A of the Internal Revenue Code of 1954, as added by section 251 of the Economic Recovery Tax Act of 1981 (95 Stat. 172) (ERTA):

GENERAL DESCRIPTION OF SECTION 422A AND ITS TRANSITIONAL RULES

Q–1: What is the significance of new section 422A of the Code entitled ''Incentive Stock Options?''

A–1: Prior to the enactment of section 422a, the tax treatment of employee stock options generally was governed by section 83 of the Code and the regulations thereunder. Under those rules, the value of a stock option constituted ordinary income to the employee when granted only if the option itself had a readily ascertainable fair market value at that time. If the option did not have a readily ascertainable value when granted, it did not constitute ordinary income at that time. Instead, when the option was exercised, the difference between the value of the stock at exercise and the option price constituted ordinary income to the employee. An employer who granted a stock option generally was allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year.

Section 422A provides for incentive stock options (ISO's). Under this new provision there will be no tax consequences when an ISO is either granted or exercised, and the employee generally will be taxed at capital gains rates when and if the stock received on exercise of the option is sold. Similarly, no business expense deduction will be allowed to the employer with respect to an ISO.

Q–2: What requirements must be met for ISO treatment under section 422A?

A–2: (a) Section 422A provides that the employee, in order to receive ISO treatment, must not dispose of the stock within two years after the option is granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, tax is deferred until disposition of the stock, but gain (in an amount equal to the lesser of (1) the fair market value of the stock on the date of exercise minus the option price or (2) the amount realized on disposition minus the option price) is treated as ordinary income and the employer is allowed a deduction at that time.

(b) In addition, for the entire time from the date of granting the option until three months before the date of exercise (expanded to 12 months if employment ceased due to permanent and total disability), the option holder must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirement are waived in the case of the death of the employee.

(c) For an option to qualify as an ISO, the following conditions must be met:

(1) The option must be granted under a plan specifying the aggregate number of shares of stock which may be issued and the employees or class of employees eligible to receive the options. This plan must be approved by the stockholders of the granting corporation within 12 months before or after the plan is adopted.

(2) The option must be granted within ten years from the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.

(3) The option must by its terms be exercisable only within ten years of the date it is granted.

(4) The option price must equal or exceed the fair market value of the stock at the time the option is granted. This requirement will be deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value.

(5) The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

(6) The employee must not, at the time the option is granted, own stock representing more than ten percent of the voting power of all classes of stock of the employer corporation or its parent or subsidiary. However, the stock ownership limitation will not apply if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.

(7) The option by its terms is not exercisable while there is outstanding any ISO which was granted to the employee at an earlier time. For this purpose, an option which has not been exercised in full is outstanding until the expiration of the period which under its initial terms it could have been exercised. Thus, the cancellation of an earlier option will not enable a subsequent option to be exercised any sooner.

(8) In the case of options granted after 1980 the terms of the plan must limit the amount of aggregate fair market value of the stock (determined at the time of the grant of the option) for which any employee may be

granted ISO's in any calendar year to not more than $100,000 plus a carryover amount. The carryover amount for an employee from any year after 1980 is one-half of the amount by which $100,000 exceeds the value at time of grant of the stock for which ISO's were granted in such prior year. Amounts may be carried over three years. Options granted in any year use up the $100,000 current year limitation first and then the carryover from the earliest year.

(d) Section 422A also provides that:

(1) Stock acquired on exercise of an ISO may be paid for with stock of the corporation granting the option.

(2) The difference between the option price and the fair market value of the stock at the exercise of an ISO is not an item of tax preference.

(3) The employee may have the right to receive additional compensation (in cash or property) at the time of exercise of the ISO so long as the additional amount is subject to inclusion in income under the provisions of sections 61 and 83 of the Code.

(4) An ISO will not be disqualified because of the inclusion of any condition not inconsistent with the qualification requirements.

Q–3: What are the transitional rules relating to ISO treatment under section 422A?

A–3: ERTA §251(c) provides the transitional rules relating to ISO treatment. That section initially limits the applicability of section 422A to options originally granted on or after January 1, 1976.

In the case of an option granted during the years 1976 through 1980, section 422A will apply only if (1) the option was exercised on or after January 1, 1981, or was outstanding on that date, and (2) the employer elects (in such manner as the Treasury Department provides) to have the option treated as an ISO (see A–4). (See A–12 for necessary section 422A qualification requirements.) The aggregate fair market value (determined at time of grant) of stock for which an employee may be granted ISO's prior to 1981 may not exceed $50,000 per calendar year and $200,000 in the aggregate for the five-year period 1976–1980.

In the case of an option granted on or after January 1, 1976, and outstanding on August 13, 1981, paragraph (1) of section 425(h) of the Code shall not apply to either any change in the option terms (or the terms of the plan under which the option was granted) or the obtaining of shareholder approval, to permit such option to qualify as an ISO, provided such change and/or shareholder approval occurs on or before August 13, 1982. (Section 425(h) of the Code requires that if an option is changed, so that it is modified, extended, or renewed, the option shall be treated as newly granted as of the date of such change.)

ELECTION PROCEDURE AND SELECTION OF OPTIONS

Q–4: What is the procedure for electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981?

A–4: NOTE: The following procedure preempts the election procedure set forth in Temporary Regulation §301.9100–4T(d) of this chapter (TD 7793, 46 FR 54538 (November 3, 1981)). If, prior to December 21, 1981, a corporation has filed an election statement that conforms to the requirements of §301.9100–4T(d) of this chapter, such an election statement will be considered to have been properly filed. An election statement filed prior to December 21, 1981, that does not meet the requirements of either §301.9100–4T(d) of this chapter or this A–4, will not be considered to have been properly filed. In any event, a corporation may re-file the election statement, conforming it to the requirements of this A–4, and such re-filing will then constitute the only election (see A–9, regarding timely rescissions, for a possible reason a corporation may want to re-file).

A corporation may file only one election statement and that statement must include all options that are to receive ISO treatment. Thus a corporation that makes an election with respect to certain options granted before 1981 may not make any subsequent election with respect to other options granted before 1981. An election shall be made by attaching a statement to the employer's income tax return (or amended return) for the first taxable year during which either an option subject to the election or an option qualifying under the rules of section 422A is exercised. An election shall be made no later than the due date (including extensions) of the income tax return for such year, except that if the due date occurs before August 14, 1982, the employer will be permitted to make the election at any time prior to August 14, 1982, on a statement attached to an amended return. In any event, no election will be permitted after the due date (taking extensions into account) of the income tax return for the taxable year including December 31, 1982.

The statement must—

(a) Contain the name, address, and taxpayer identification number of the corporation.

(b) Identify the election as an election under section 251(c)(1)(B) of the Economic Recovery Tax Act of 1981.

(c) Specify, by employee, the options to which the election applies. For each option so elected, the filing must state the option's date of original grant (and, if applicable, date of most recent modification) and total exercise price (*i.e.*, the total number of

shares subject to the option multiplied by the price per share).

All options that are subject to the election must meet the section 422A qualification requirements (see A–2(c)) at the time the election statement is filed. The only exception to this rule is the requirement, when necessary, of securing shareholder approval (see A–32 and A–34).

Q–5: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select only those options that it wants to receive ISO treatment?

A–5: Yes. However the original grant dates—or later grant dates for options with section 425(h) amendments (see A–9)—of the options selected for ISO treatment will determine the new sequencing order for purposes of the ISO sequential exercise restriction (see A–2(c)(7)). For example consider the case of options granted in 1977, 1978, and 1979, and assume that in 1980 the 1978 option was modified to add a term beneficial to the employee (a modification which under 425(h) would be treated as the granting of a new option). If the 1977, 1978 (as modified), and 1979 options are now elected as ISO's, the sequencing order is as follows: the 1977 option must be exercised first, the 1979 option second, and the 1978 option (as modified) third. See also A–9 and A–38.

Q–6: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select options on an option-by-option basis and/or an employee-by-employee basis?

A–6: Yes. Subject to the $50,000 per year and $200,000 aggregate limits (see A–3), a corporation may select for ISO treatment any or all options granted to any or all employees, subject only to plan requirements as to who must be benefited under a plan, as among different classes of employees.

Q–7: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select only a portion of the elected option to receive such treatment?

A–7: Yes. Subject to the $50,000 per year and $200,000 aggregate limits (see A–3), a corporation may select for ISO treatment any portion of any option. If the option is not exercised prior to January 21, 1982, the option must be amended so that the ISO portion is clearly identified. When such a ''split'' option is exercised, separate stock certificates must be issued (or reissued)—one for the ISO stock and one for the non-ISO stock. See also A–15 and A–18.

ELIGIBILITY REQUIREMENTS AND ISSUES INVOLVING PRE-ENACTMENT MODIFICATIONS, DOLLAR LIMITATIONS, AND DUAL PLANS

Q–8: Is an option originally granted prior to January 1, 1976, and amended on or after January 1, 1976, eligible for ISO treatment?

A–8: No. For purposes of ISO eligibility, the controlling date is the date of original grant. A modification, extension, or renewal on or after January 1, 1976, of any option originally granted before that date, will not make such option eligible for ISO treatment, regardless of whether or not the option, as so modified, extended, or renewed, would be treated as newly granted within the meaning of section 425(h).

Q–9: If an option granted on or after January 1, 1976, was amended between its date of grant and August 13, 1981, will such an amendment affect the option's eligibility for ISO treatment?

A–9: An amendment to an otherwise eligible option (or plan) prior to August 13, 1981, will be subject to the rules of section 425(h). If, pursuant to section 425(h), the amendment is a modification, extension, or renewal of the option, such amendment shall be considered as the granting of a new option. In order for such an option to be eligible for ISO treatment, the option (and plan) must comply with the section 422A qualification requirements (see A–2(c)). The option will be deemed to have been granted on the date it was amended. Thus, the option price cannot be less than the fair market value of the stock on that date. If the corporation wishes to retain the original grant price (and grant date) of the option, the corporation may do so by rescinding the amendment that was either a modification, extension, or renewal pursuant to section 425(h), so long as such rescission occurs prior to the earliest of the exercise of the option, the election of ISO treatment, and August 14, 1982. To be effective, such rescission must apply to the entire option. For example, in the case of a $100,000 option granted in 1978 and amended in 1980, the corporation could not rescind the modification as to only half of the option, and then elect for ISO treatment both $50,000 of the option granted in 1978 and $50,000 of the option as amended in 1980.

Q–10: An option granted during 1978 was amended during 1980 to add the following features: An alternative stock appreciation right, the right to exercise the option with previously-acquired corporate stock, and the right to receive a cash bonus upon the exercise of the option. At the same time, the exercise period of the option was extended from five to ten years and the post-employment exercise period was extended from 3 to 18 months. If the option is to

be elected as an ISO, which of the above amendments is either a modification, extension, or renewal within the meaning of section 425(h) so that the option will be treated as newly granted on the date it was amended?

A–10: Any one of the above amendments will cause the option, pursuant to section 425(h), to be treated as newly granted on the date it was amended.

Q–11: An option granted during 1978 was amended during 1980 to add the right to exercise the option with previously acquired corporate stock. During 1981, the corporation properly elected ISO treatment for the amended option and, pursuant to section 425(h), adjusted the option price upward so that it equaled the fair market value of the stock subject to the option as of the date of the 1980 amendment. During 1982, the employee intends to exercise the option and will pay cash. Under these circumstances, is the employee entitled to exercise the option at the 1978 option price?

A–11: No. The option price, as amended in 1980, is the option price. The application of section 425(h) to option amendments is not affected by whether or not the employee actually benefits from such amendments (but see A–9 regarding timely rescissions).

Q–12: Is an option granted on or after January 1, 1976, and exercised on or after January 1, 1981, eligible for ISO treatment, if, at the time of exercise, the option (or plan) did not meet all of the qualification requirements of section 422A and the transitional rules (see A–2(c) and A–3, respectively)?

A–12: No. Except in cases described in A–13 through A–15, and A–34, in order for an option to be eligible for ISO treatment it must, at the time of exercise, conform to all of the qualification requirements of section 422A and the transition rules. It is not possible to amend an exercised option retroactively, in order to correct non-conforming or missing terms, or to rescind an improper exercise.

Q–13: Is an option granted on or after January 1, 1976, and exercised on or after January 1, 1981, eligible for ISO treatment if, at the time of exercise, the terms of the option did not contain the ISO sequential exercise restriction (see A–2(c)(7))?

A–13: If the option was exercised prior to January 21, 1982, without containing the ISO sequential exercise restriction, such option may still be eligible for ISO treatment. The absence of the restriction will not disqualify an option if the employee in fact had no prior outstanding ISO's at the time the option in question was exercised. If the option was exercised on or after January 21, 1982, the absence of the ISO sequential exercise restriction will not disqualify an option if the employee in fact had no prior outstanding ISO's at the time the option in question was granted. In order to identify prior outstanding ISO's, it will be necessary to take into account all options either elected or qualifying for ISO treatment (see A–5, A–9, and A–38).

Q–14: Is an option granted and exercised during 1981 eligible for ISO treatment if, at the time of exercise, the terms of the plan pursuant to which the option was granted did not contain the $100,000 per year limit on ISO grants (see A–2(c)(8))?

A–14: If the option was exercised prior to January 21, 1982, the absence from the plan of the $100,000 per year limit will not disqualify the option. ISO treatment will only be available, however, for exercised amounts that do not exceed the $100,000 limit. Those amounts in excess of the limit will be treated as non-ISO's. If it is necessary to ''split'' an exercised option because the $100,000 limit has been exceeded, separate stock certificates must be issued (or reissued) no later than January 21, 1982, one for the ISO stock and one for the non-ISO stock. If the option was not exercised prior to January 21, 1982, the rules of A–18 will apply.

Q–15: Is an option granted during the years 1976 through 1980, and exercised during 1981, eligible for ISO treatment if, at the time of exercise, the option, either alone or in conjunction with similarly granted options, exceeded the $50,000 per year limit (or the $200,000 aggregate limit) on ISO grants (see A–3)?

A–15: If the option was exercised prior to January 21, 1982, the fact that the aggregate fair market value of the stock exceeded the $50,000 per year limit (or the $200,000 aggregate limit) will not prevent the election of up to $50,000 of the option as an ISO (subject to the $200,000 aggregate limit). Those amounts in excess of the applicable dollar limits cannot be elected as ISO's. If it is necessary to ''split'' an exercised option because the applicable dollar limits have been exceeded, separate stock certificates must be issued (or reissued) no later than January 21, 1982, one for the ISO stock and one for the non-ISO stock (see also A–7). If the option was not exercised prior to January 21, 1982, the rules of A–18 will apply.

Q–16: Do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) apply to all options granted to an employee or only to elected and qualifying ISO's?

A–16: All three limits apply only to elected and qualifying ISO's.

Q–17: Do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) apply to the fair market value of the stock granted, or to the option price of the options granted?

A–17: The dollar limits apply to the fair market value of the stock granted. Thus, an employee who is also a 10 percent shareholder would be permitted to receive an ISO grant to purchase $100,000 worth of stock at an option price of $110,000 (see A–2(c)(6)).

Q–18: How do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000

aggregate limits (see A–3) apply to an option granted on or after January 1, 1976, and not exercised prior to January 21, 1982?

A–18: Such an option will not qualify for ISO treatment if, at the time it is exercised, the option amount is in excess of the applicable dollar limit. In order for such an option to qualify for ISO treatment, it must be ''split'' into an ISO and a non-ISO portion so that the ISO portion of the option does not exceed the applicable dollar limit. This option ''split'' must be accomplished prior to the exercise of the original option and the ISO portion of the option must be clearly identified. Any ''split'' option that was required, by its original terms, to be exercised in full, will still be required to be exercised in full after it is ''split.'' Upon the exercise of a ''split'' option, separate stock certificates must be issued—one for the ISO stock and one for the non-ISO stock. Additionally, if the option was granted on or after January 1, 1981, the terms of the plan pursuant to which the option was granted must be amended to add the $100,000 per year limit—before the option is exercised.

Q–19: How does the $50,000 per year limit (see A–3) apply to the case of an employee who was granted $100,000 of options in 1979, and who proposes to exercise these options $50,000 in 1982 and $50,000 in 1983?

A–19: Only $50,000 (valued as of the date of grant) of the stock for which options were granted in 1979 will be eligible for ISO treatment. The $50,000 per year limit relates only to the year of grant, not to the year of vesting (as in the case of installment options) or exercise. Additionally, no carryover provision applies to the $50,000 per year limit. Thus, even if the employee had not been granted any options in prior years, the result described above would not change.

Q–20: Is it permissible for a corporation to grant ISO's and non-ISO's under the same plan, or must such options be granted pursuant to separate plans?

A–20: Both ISO's and non-ISO's may be granted pursuant to one plan so long as such plan, by its terms, meets all of the ISO qualification requirements (see A–2 (c)). Additionally, each option granted pursuant to such a ''dual'' plan must be clearly identified as to its status, *i.e.*, ISO or non-ISO.

Q–21: May a single option agreement, issued pursuant to a plan, grant both ISO's and non-ISO's, or must such option agreements grant either only ISO's or only non-ISO's?

A–21: Both ISO's and non-ISO's may be granted pursuant to a single option agreement, so long as each option is clearly identified as to its status, *i.e.*, ISO or non-ISO, and none of the options are subject to a ''tandem'' exercise arrangement (see A–39).

Q–22: When either amending an existing plan or creating a new plan that is to grant ISO's, is it necessary under the ISO qualification requirements (see A–2(c)) to specify only the aggregate number of total shares issuable under the plan, or must the aggregate numbers of ISO's and non-ISO's be specified?

A–22: Only the aggregate number of total shares issuable under the plan must be specified.

Q–23: Must either an option, or the plan pursuant to which the option is granted, contain a specific provision restricting the exercise of any ISO to within 3 months of termination of the employee's employment (see A–2(b))?

A–23: No. An otherwise eligible option will receive ISO treatment if it is, in fact, exercised within 3 months of termination of the employee's employment (except in cases of disability or death). Moreover, an option term that permits exercise beyond 3 months after termination of employment, will not disqualify an option from receiving ISO treatment.

Q–24: In order for an option to be eligible for ISO treatment, the option price must equal or exceed the fair market value of the stock subject to the option when the option is granted. This requirement will be deemed to have been satisfied if, at the time of grant, there was a good faith attempt to accurately value the stock—even if such valuation should subsequently prove to be in error (see A–2(c)(4)). Do similar good faith rules apply to the $100,000 per year and 50 percent carryover limits (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) relating to the value of ISO options granted per employee?

A–24: Yes.

REQUIRED OPTION AND PLAN AMENDMENTS

Q–25: What types of amendments, under the transitional rule governing changes in the terms of options and plans (see A–3), will not invoke the application of section 425(h)?

A–25: The transitional rule waives the applicability of section 425(h) only with respect to amendments which are necessary in order to permit an option or plan to meet the minimum qualification requirements of section 422A (see A–2(c)). Amendments to add or delete permissible terms (such as the right to use previously acquired corporate stock to exercise the option) do not fall within the waiver of section 425(h).

Q–26: Is an option granted after August 13, 1981, under a plan (or option terms) which fails to meet the qualification requirements of section 422A (see A–2(c)), eligible for ISO treatment?

A–26: No. However, prior to being exercised, such an option (or its plan) may be amended to meet the qualification requirements of section 422A and thus become eligible for ISO treatment. All such amendments, where an option is granted after August 13, 1981, will be subject to the rules of section 425(h) (see A–3). Thus, for example, if an option is granted on September 1, 1981, it may qualify as an ISO only if it is amended, and the option price is at least equal to the fair

market value of the stock as of the amendment date.

Q–27: May the terms of an outstanding option that was granted on or after January 1, 1981, and that automatically qualified for ISO treatment, be selectively amended so as to disqualify the option from receiving ISO treatment? May the option be cancelled?

A–27: Yes. However, despite either the cancellation of the option or any disqualifying amendment to the option (or the plan pursuant to which the option was granted), the original option will, for purposes of the ISO sequential exercise restriction, be treated as an outstanding ISO until such option, by its original terms, expires by reason of lapse of time (see A–2(c)(7)).

Q–28: May a non-ISO plan be amended so as to qualify only prospectively granted options for ISO treatment?

A–28: Yes. Amendments to a non-ISO plan, so as to meet the section 422A qualification requirements (see A–2(c)), will only apply to previously granted and outstanding options when such amendments, by their terms, are clearly intended to have retroactive effect.

Q–29: If a corporation grants new ISO's in exchange for the cancellation of outstanding non-ISO's, will such an exchange violate either the 422A qualification requirements (see A–2(c)) or the transition rules (see A–3)?

A–29: No, so long as such an exchange does not constitute a ''tandem'' exercise arrangement (see A–39).

SHAREHOLDER APPROVAL ISSUES

Q–30: If a plan received shareholder approval within 12 months before or after the date such plan was originally adopted and it is being amended to conform to the qualification requirements of section 422A (see A–2(c)), will new shareholder approval be required?

A–30: For purposes of the section 422A qualification requirements, new shareholder approval will be required only if the original plan did not specify the aggregate number of issuable shares or identify the eligible employees (or class of employees).

Q–31: Does the amendment of a plan to add the $100,000 per year and 50 percent carryover limits (see A–2(c)(8)), relating to options granted on or after January 1, 1981, require new shareholder approval?

A–31: No.

Q–32: If a plan never received shareholder approval, or did not receive such approval within 12 months before or after the plan was adopted, will such plan conform to the qualification requirements of section 422A (see A–2(c)) if shareholder approval is obtained prior to August 14, 1982?

A–32: Yes, but only if an option granted pursuant to the plan was outstanding on August 13, 1981 (see A–3). If no option granted pursuant to the plan was outstanding on August 13, 1981, such plan must be re-adopted by the granting corporation and, if necessary, amended to meet the section 422A qualification requirements. Shareholder approval must be obtained within 12 months before or after the date the plan is re-adopted. Consequently, any option granted after August 13, 1981, and before the date the plan is re-adopted, will be treated as newly granted on the date of re-adoption of the plan.

Q–33: If an option was granted pursuant to no plan at all and the option was outstanding on August 13, 1981, may a plan now be instituted and shareholder approval obtained, as part of the amendments permitted under the transitional rules (see A–3)?

A–33: Yes.

Q–34: Assuming that shareholder approval is required with respect to certain amendments made to conform an option outstanding on August 13, 1981 (or its plan), to the qualification requirements of section 422A (see A–2(c)), may such option be exercised prior to securing shareholder approval and still be eligible for ISO treatment?

A–34: Yes, so long as shareholder approval is secured within the one-year period specified by the transitional rules (see A–3).

SEQUENTIAL EXERCISE ISSUES

Q–35: Will the existence (or exercise) of prior stock options which are neither elected nor qualified to receive ISO treatment, ever prevent the exercise of an ISO under the 422A sequential exercise restriction (see A–2)?

A–35: No. However, if an option that is either elected or qualified to receive ISO treatment, contains sequencing restrictions that refer to options other than ISO's, the option will continue to be burdened by such restrictions. The deletion of such non-ISO sequencing restrictions from the option is not an amendment necessary in order to qualify an option for ISO treatment as permitted by the transitional rules (see A–3). Consequently, section 425(h) would be applicable to such an amendment.

Q–36: Under the sequencing rules applicable to section 422 qualified stock options, an option was permitted to be exercised out of sequence so long as it was issued at a higher price than prior outstanding options (section 422(c)(6)). Will a similar exception to the sequencing restriction be applicable to ISO's?

A–36: No. Section 422A does not contain such an exception to the sequencing restriction.

Q–37: How does the section 422A sequential exercise restriction (see A–2(c)(7)) apply to an ISO granted in one year that, by its terms, can only be exercised in installments over a period of years?

A–37: Such an installment ISO is the grant of a single option. The section 422A sequential exercise restriction would restrict the exercise of any later-granted ISO until either the exercise or expiration of all installments of this earlier-granted ISO.

Q–38: Assume that an option granted and exercised during January of 1982 automatically qualifies, by its terms, for ISO treatment. During February of 1982, the same employee exercised a second option, one that had been granted during 1978. Prior to the exercise of the 1978 option, it was amended under the transitional rules (see A–3) so that it would conform to the section 422A qualification requirements (see A–2(c)). If the 1978 option is properly elected to receive ISO treatment (see A–4), will such an election adversely affect the 1982 option's status as an ISO?

A–38: Yes. The election of the 1978 option to receive ISO treatment will automatically disqualify the 1982 option. If the 1982 option is to qualify as an ISO, it cannot be exercised prior to the exercise or expiration of all ISO's previously granted and outstanding on the 1982 option's date of grant (see A–2(c)(7)). When the 1982 option was granted during January of 1982, the 1978 option was already granted and outstanding for purposes of the section 422A sequential exercise restriction.

RECEIPT OF PROPERTY OR CASH UPON EXERCISE OF AN ISO

Q–39: Section 422A provides that ISO treatment will be available even though the employee has the right to receive cash or other property at the time of the exercise of the option, so long as such property is subject to inclusion in income under section 83 (see A–2(d)(3)). To what extent does section 422A permit the use of tandem options and stock appreciation rights (SARs) in connection with ISO's?

A–39: A tandem stock option, wherein two options are issued together and the exercise of one affects the right to exercise the other, is not permitted because such a tandem option arrangement may be used to evade the section 422A qualification requirements (see A–2(c)).

A tandem ISO–SAR, wherein an ISO and an SAR are granted together and the exercise of one affects the right to exercise the other, is permitted so long as the SAR, by its terms, meets the following requirements:

(a) The SAR will expire no later than the expiration of the underlying ISO.

(b) The SAR may be for no more than 100% of the spread, *i.e.*, the difference between the exercise price of the underlying option and the market price of the stock subject to the underlying option at the time the SAR is exercised.

(c) The SAR is transferable only when the underlying ISO is transferable, and under the same conditions.

(d) The SAR may be exercised only when the underlying ISO is eligible to be exercised.

(e) The SAR may be exercised only when there is a positive spread, *i.e.*, when the market price of the stock subject to the option exceeds the exercise price of the option.

If all of the above requirements are met, for purposes of the 422A sequential exercise restriction (see A–2(c)(7)), a tandem ISO–SAR will be considered exercised in full when either the underlying ISO or the SAR is exercised. Additionally, SAR's may be paid in either cash or property, or a combination thereof, so long as the section 83 income inclusion rule applies to any property so transferred.

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PART 15—TEMPORARY INCOME TAX REGULATIONS RELATING TO EXPLORATION EXPENDITURES IN THE CASE OF MINING

Sec.

15.0–1 Scope of regulations in this part.
15.1–1 Elections to deduct.
15.1–2 Revocation of election to deduct.
15.1–3 Elections as to method of recapture.
15.1–4 Special rules.

AUTHORITY: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805.

SOURCE: T.D. 6907, 31 FR 16776, Dec. 31, 1966, unless otherwise noted.

§ 15.0–1 Scope of regulations in this part.

The regulations in this part relate to expenditures of the type described in section 615(a) or in section 617(a)(1) paid or incurred after September 12, 1966. The regulations in this part do not apply to the income tax treatment of mining exploration expenditures paid or incurred before September 13, 1966, and no election made pursuant to the provisions of the regulations in this part shall have any effect on the income tax treatment of exploration expenditures paid or incurred before such date. See § 15.1–4 for rules relating to treatment of exploration expenditures paid or incurred during taxable years beginning before September 13, 1966, and ending after September 12, 1966.

§ 15.1–1 Elections to deduct.

(a) *Manner of making election*—(1) *Election to deduct under section 617(a).* The election to deduct exploration expenditures as expenses under section 617(a) may be made by deducting such

expenditures in the taxpayer's income tax return for the first taxable year ending after September 12, 1966, for which the taxpayer desires to deduct exploration expenditures which are paid or incurred by him during such taxable year and after September 12, 1966. This election may be exercised by deducting such expenditures either in the taxpayer's return for such taxable year or in an amended return filed before the expiration of the period for filing a claim for credit or refund of income tax for such taxable year. Where the election is made in an amended return for a taxable year prior to the most recent year for which the taxpayer has filed a return, the taxpayer shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the election, for all taxable years affected by the election. See section 617(a)(2)(C) for provisions relating to the tolling of the statute of limitations for the assessment of any deficiency for any taxable year, to the extent the deficiency is attributable to an election under section 617(a). In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as the deduction for charitable contributions, the foreign tax credit, net operating loss and other deductions or credits the amount of which is limited by the taxpayer's taxable income, and the effect that adjustments of any such items have on other taxable years. Amended returns filed for taxable years subsequent to the taxable year for which the election under section 617(a) is made by amended return shall apply the recapture provisions of subsections (b)(1)(B), (c), and (d) of section 617.

(2) *Election to deduct under section 615*—(i) *General rule.* The election to deduct exploration expenditures under section 615 shall be made in a statement filed with the district director, or director of the regional service center, with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year ending after September 12, 1966, during which the taxpayer pays or incurs expenditures which are within the scope of section 615 and which are paid or incurred by him after September 12, 1966, this statement shall be attached to the taxpayer's income tax return for such taxable year. If the election is made after the time prescribed for filing such return but before the expiration of the period (described in paragraph (d)(1) of this section) for making the election under section 615(e), the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him during such taxable year after such date. The statement shall clearly indicate that the taxpayer elects to have section 615 apply to all amounts deducted by him with respect to mining exploration expenditures paid or incurred after September 12, 1966. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year ending after September 12, 1966, in which he pays or incurs mining exploration expenditures. Except as provided, in subdivision (ii) of this subparagraph, if the taxpayer does not file such a statement within the period prescribed by section 615(e) and paragraph (d)(1) of this section, any amounts deducted by him with respect to exploration expenditures paid or incurred by him after September 12, 1966, will be deemed to have been deducted pursuant to an election under section 617(a).

(ii) *Exception.* The last sentence of subdivision (i) of this subparagraph shall not apply if all mining exploration expenditures which are paid or incurred by the taxpayer after September 12, 1966, and which are deducted by him in his income tax return for the first taxable year ending after September 12, 1966, during which he pays or incurs such expenditures are outside the scope of section 617(a). For example, assume that, in his return for his first taxable year ending after September 12, 1966, a taxpayer deducts mining exploration expenditures paid or incurred after September 12, 1966, and does not

attach to his return the statement described in subdivision (i) of this subparagraph. However, all of the exploration expenditures paid or incurred by the taxpayer after September 12, 1966, and before the end of the taxable year were paid or incurred with respect to minerals located neither in the United States nor on the Outer Continental Shelf. The taxpayer will be deemed to have made an election under section 615(e) by deducting all or part of those expenditures as expenses in his income tax return.

(b) *Information to be furnished.* A taxpayer who makes or has made an election under either section 615(e) or section 617(a) to deduct expenditures paid or incurred after September 12, 1966, shall indicate clearly on his income tax return for each taxable year for which he deducts any such expenditures the amount of the deduction claimed under section 615 (a) or (b) or section 617(a) with respect to each property or area of interest. Such property or area of interest shall be identified by a description sufficiently adequate to permit application of the recapture rules of section 617 (b), (c), and (d) and the rules of section 615(g) (relating to effect of transfer of mineral property).

(c) *Effect of election.* A taxpayer who has made an election under section 615(e) may never make an election under section 617(a) unless, within the period set forth in section 615(e) and paragraph (b)(1) of § 15.1–2, he revokes his election under section 615(e). A taxpayer who has made an election under section 617(a) may never make an election under section 615(e) unless, within the period set forth in section 615(e) and paragraph (b)(1) of § 15.1–2, he revokes his election under section 617(a). A taxpayer who has made, and has not revoked, an election under section 617(a) may not, in his return for the taxable year for which the election is made or for any subsequent taxable year, charge to capital account any expenditures which are within the scope of section 617(a), and he must deduct all such expenditures as expenses. Except as provided in paragraph (a)(2) of § 1.615–2 of this chapter (Income Tax Regulations), a taxpayer who makes an election under 615(e) may not change his treatment of exploration expenditures deducted, deferred, or capitalized pursuant to such election unless he revokes the election made under section 615(e).

(d) *Time for making election*—(1) *Election under section 615(e).* A taxpayer may not make an election under section 615(e) after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year ending after September 12, 1966, in which the taxpayer pays or incurs expenditures to which section 615(a) would apply if an election were made under section 615(e). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return. An election under section 615(e) may not be made after the expiration of the 3-year period even though the taxpayer charged to capital account, or erroneously deducted as development expenditures under section 616, all mine exploration expenditures paid or incurred by him after September 12, 1966, and before the end of his first taxable year ending after September 12, 1966, in which he paid or incurred such expenditures.

(2) *Election under section 617(a).* The election under section 617(a) may be made at any time before the expiration of the period prescribed for filing a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the taxpayer desires to deduct exploration expenditures under section 617.

(3) *Timely mailing treated as timely filing.* Section 7502 (relating to timely mailing treated as timely filing) shall apply in determining the date when an election under either section 615(e) or section 617(a) is made.

§ 15.1–2 Revocation of election to deduct.

(a) *Manner of revoking election.* A taxpayer may revoke an election made by him under section 615(e) or section 617(a) by filing with the internal revenue officer with whom the taxpayer's income tax return is required to be filed, within the periods set forth in

paragraph (b) of this section, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the election previously made by him with respect to the deduction of mining exploration expenditures paid or incurred after September 12, 1966, and states with whom the document making the election was filed. A taxpayer revoking such an election shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the revocation of election, for all taxable years affected by the revocation of election. See section 617(a)(2)(C) for provisions relating to the tolling of the statute of limitations for the assessment of any deficiency for any taxable year, to the extent the deficiency is attributable to an election or revocation of election under section 617(a). In applying the revocation of an election to the years affected there shall be taken into account the effect that any adjustments resulting from the revocation of election shall have on other items affected thereby, such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's taxable income, and the effect that adjustments of any such items have on other taxable years.

(b) *Time for revoking election*—(1) *Election under section 615(e).* An election under section 615(e) may be revoked at any time before the expiration of the 3-year period described in paragraph (d)(1) of § 15.1–1. Such an election may not be revoked after the expiration of the 3-year period.

(2) *Election under section 617(a).* An election under section 617(a) may be revoked before the expiration of the last day of the third month following the month in which the final regulations issued under the authority of section 617 are published in the FEDERAL REGISTER. After the expiration of this period, a taxpayer who has made an election under section 617(a) may not revoke that election unless he obtains the consent of the Secretary or his delegate in the manner to be set forth in the final regulations under section 617.

(c) *Additional information to be furnished by a transferor of mineral property.* If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures paid or incurred after September 12, 1966, to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, the statement submitted pursuant to paragraph (a) of this section shall state that such property has been so transferred and shall identify the transferee, the property transferred, and the date of the transfer.

§ 15.1–3 Elections as to method of recapture.

(a) *In general.* If the taxpayer so elects with respect to all mines with respect to which deductions have been allowed under section 617(a) and which reach the producing stage during a taxable year, he shall include in gross income for the taxable year an amount equal to the adjusted exploration expenditures with respect to such mines (determined under section 617(f)(1)). The amount so included in income shall be treated for purposes of Subtitle A of the Internal Revenue Code as expenditures which are paid or incurred on the respective dates on which the mines reach the producing stage and which are properly chargeable to capital account. If the taxpayer does not make this election for a taxable year during which any mine with respect to which deductions have been allowed under section 617(a) reaches the producing stage, the deduction for depletion under section 611 with respect to the property (whether determined under § 1.611–2 of this chapter (Income Tax Regulations) or under section 613) shall be disallowed until the amount of depletion which would be allowable but for section 617(b)(1)(B) equals the amount of the adjusted exploration expenditures with respect to the mine. The fact that a taxpayer does not make the election described in the first sentence of this paragraph for a taxable year during which mines with respect to which deductions have been allowed under section 617(a) reach the producing stage shall not preclude the taxpayer from making the election with

respect to other mines which reach the producing stage during a subsequent taxable year. However, an election may not be made for any taxable year with respect to any mines which reached the producing stage during a preceding taxable year.

(b) *Manner of making elections.* A taxpayer will be considered to have made an election in accordance with the manner in which the adjusted exploration expenditures with respect to the mines reaching the producing stage during a taxable year are treated in his return for such taxable year.

(c) *Time for making election.* The election described in paragraph (a) of this section may be made, or changed by filing an amended return, not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year.

§ 15.1–4 Special rules.

(a) *Taxable years beginning before September 13, 1966, and ending after September 12, 1966*—(1) *General rule.* An election made under section 615(e) or section 617(a) applies only to expenditures paid or incurred after September 12, 1966. The income tax treatment of exploration expenditures paid or incurred before September 13, 1966, will be determined in accordance with the provisions of section 615 prior to its amendment by the Act of September 12, 1966 (Pub. L. 89–570, 80 Stat. 759). If a taxpayer makes an election under section 615(e) in his income tax return for a taxable year beginning before September 13, 1966, and ending after September 12, 1966, amounts deducted under section 615 with respect to expenditures paid or incurred during such taxable year but before September 13, 1966, will be taken into account in determining whether the $100,000 limitation set forth in section 615(a) is reached during 1966. Similarly, a taxpayer making an election under section 615(e) shall take into account expenditures deducted under section 615 for periods prior to September 13, 1966, in determining when the $400,000 overall limitation set forth in section 615(c) is reached. The fact that a taxpayer deducts under section 615 expenditures paid or incurred prior to September 13, 1966, shall not affect his right to make an election under section 617(a) to deduct under section 617 expenditures paid or incurred after September 12, 1966.

(2) *Allocation in case of inadequate records.* If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before September 13, 1966, and ending after September 12, 1966, but his records as to any mine or property are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after September 12, 1966, and the amount paid or incurred on or before such date, the exploration expenditures as to which the records are inadequate paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part year (that is, the part occurring before September 13, 1966, and the part occurring after September 12, 1966) in the ratio which the number of days in such part year bears the number of days in the entire taxable year. For example, if the records of a calendar year taxpayer for 1966 are inadequate to permit a determination of the amount of exploration expenditures paid or incurred with respect to a certain mine or property after September 12, 1966, and the amount paid or incurred before September 13, 1966, $^{255}/_{365}$ of the total exploration expenditures paid or incurred by the taxpayer with respect to the mine or property during 1966 shall be allocated to the period beginning January 1, 1966, and ending September 12, 1966, and $^{110}/_{365}$ of the total exploration expenditures paid or incurred with respect to the mine or property during 1966 shall be allocated to the period beginning September 13, 1966, and ending December 31, 1966.

(3) *Partnership elections.* With respect to exploration expenditures paid or incurred by a partnership before September 13, 1966, the option to deduct under section 615(a) and the election to defer under section 615(b) shall be made by the partnership, rather than by the individual partners. All elections under sections 615(e), 617(a), or 617(b) as to the tax treatment of a partner's distributive share of exploration expenditures paid or incurred by any partnership of which he is a member shall be made by the individual partner, rather than by the partnership.

(b) *Effect of transfer of mineral property.* The binding effect of a taxpayer's election under section 615(e) shall not be affected by his receiving property with respect to which deductions have been allowed under section 617(a). The binding effect of a taxpayer's election under section 617(a) shall not be affected by his receiving property with respect to which deductions have been allowed under section 615 pursuant to an election made under section 615(e). However, see section 615(g)(2) for rules under which amounts deducted under section 615 by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 617(a).

PART 15a—TEMPORARY INCOME TAX REGULATIONS UNDER THE INSTALLMENT SALES REVISION ACT

Sec.

15a.453–0 Taxable years affected.
15a.453–1 Installment method reporting for sales of real property and casual sales of personal property.
15a.453–2 Installment obligations received as liquidating distribution. [Reserved]

AUTHORITY: 26 U.S.C. 453(i) and 7805.

§ 15a.453–0 Taxable years affected.

(a) *In general.* Except as otherwise provided, the provisions of § 15a.453–1 (a) through (e) generally apply to installment method reporting for sales of real property and casual sales of personal property occurring after October 19, 1980. See 26 CFR § 1.453–1 (rev. as of April 1, 1980) for the provisions relating to installment method reporting for sales of real property and casual sales before October 20, 1980 (except as provided in paragraph (b) of this section) and for provisions relating to installment sales by dealers in personal property occurring before October 20, 1980.

(b) *Certain limitations.* The provisions of prior law (section 453(b) of the Internal Revenue Code of 1954, in effect as of October 18, 1980) which required that the buyer receive no more than 30 percent of the selling price in the taxable year of the installment sale and that at least two payments be received shall not apply to reporting for casual installment sales of personal property and installment sales of real property occurring in a taxable year ending after October 19, 1980.

[T.D. 7768, 46 FR 10709, Feb. 4, 1981; 46 FR 43036, Aug. 26, 1981]

§ 15a.453–1 Installment method reporting for sales of real property and casual sales of personal property.

(a) *In general.* Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, income from a sale of real property or a casual sale of personal property, where any payment is to be received in a taxable year after the year of sale, is to be reported on the installment method.

(b) *Installment sale defined*—(1) *In general.* The term ''installment sale'' means a disposition of property (except as provided in paragraph (b)(4) of this section) where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The term ''installment sale'' includes dispositions from which payment is to be received in a lump sum in a taxable year subsequent to the year of sale. For purposes of this paragraph, the taxable year in which payments are to be received is to be determined without regard to section 453(e) (relating to related party sales), section (f)(3) (relating to the definition of a ''payment'') and section (g) (relating to sales of depreciable property to a spouse or 80-percent-owned entity).

(2) *Installment method defined*—(i) *In general.* Under the installment method, the amount of any payment which is income to the taxpayer is that portion of the installment payment received in that year which the gross profit realized or to be realized bears to the total contract price (the ''gross profit ratio''). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(ii) *Selling price defined.* The term ''selling price'' means the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the buyer) and, for installment sales in taxable years ending after October 19, 1980, without reduction to reflect any

selling expenses. Neither interest, whether stated or unstated, nor original issue discount is considered to be a part of the selling price. See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iii) *Contract price defined.* The term ''contract price'' means the total contract price equal to selling price reduced by that portion of any qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section), assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property (adjusted, for installment sales in taxable years ending after October 19, 1980, to reflect commissions and other selling expenses as provided in paragraph (b)(2)(v) of this section). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iv) *Qualifying indebtedness.* The term ''qualifying indebtedness'' means a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property. The term ''qualifying indebtedness'' does not include an obligation of the taxpayer incurred incident to the disposition of the property (*e.g.*, legal fees relating to the taxpayer's sale of the property) or an obligation functionally unrelated to the acquisition, holding, or operating of the property (*e.g.*, the taxpayer's medical bill). Any obligation created subsequent to the taxpayer's acquisition of the property and incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of disposition of the property is not qualifying indebtedness if the arrangement results in accelerating recovery of the taxpayer's basis in the installment sale.

(v) *Gross profit defined.* The term ''gross profit'' means the selling price less the adjusted basis as defined in section 1011 and the regulations thereunder. For sales in taxable years ending after October 19, 1980, in the case of sales of real property by a person other than a dealer and casual sales of personal property, commissions and other selling expenses shall be added to basis for purposes of determining the proportion of payments which is gross profit attributable to the disposition. Such additions to basis will not be deemed to affect the taxpayer's holding period in the transferred property.

(3) *Payment*—(i) *In general.* Except as provided in paragraph (e) of this section (relating to purchaser evidences of indebtedness payable on demand or readily tradable), the term ''payment'' does not include the receipt of evidences of indebtedness of the person acquiring the property (''installment obligation''), whether or not payment of such indebtedness is guaranteed by a third party (including a government agency). For special rules regarding the receipt of an evidence of indebtedness of a transferee of a qualified intermediary, see §§ 1.1031(b)–2(b) and 1.1031(k)–1(j)(2)(iii) of this chapter. A standby letter of credit (as defined in paragraph (b)(3)(iii) of this section) shall be treated as a third party guarantee. Payments include amounts actually or constructively received in the taxable year under an installment obligation. For a special rule regarding a transfer of property to a qualified intermediary followed by the sale of such property by the qualified intermediary, see § 1.1031(k)–1(j)(2)(ii) of this chapter. Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment. For a special rule regarding a transfer of property in exchange for an obligation that is secured by cash or a cash equivalent held in a qualified escrow account or a qualified trust, see § 1.1031(k)–1(j)(2)(i) of this chapter. Payment may be received in cash or other property, including foreign currency, marketable securities, and evidences or indebtedness which are payable on demand or readily tradable. However, for special rules relating to the receipt of certain property with respect to which gain is not recognized, see paragraph (f) of this section (relating to transactions described in sections 351, 356(a) and 1031). Except as provided in § 15a.453–2 of

these regulations (relating to distributions of installment obligations in corporate liquidations described in section 337), payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer. For purposes of determining the amount of payment received in the taxable year, the amount of qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section) assumed or taken subject to by the person acquiring the property shall be included only to the extent that it exceeds the basis of the property (determined after adjustment to reflect selling expenses). For purposes of the preceding sentence, an arrangement under which the taxpayer's liability on qualifying indebtedness is eliminated incident to the disposition (*e.g.*, a novation) shall be treated as an assumption of the qualifying indebtedness. If the taxpayer sells property to a creditor of the taxpayer and indebtedness of the taxpayer is cancelled in consideration of the sale, such cancellation shall be treated as payment. To the extent that cancellation is not in consideration of the sale, see §§ 1.61–12(b)(1) and 1.1001–2(a)(2) relating to discharges of indebtedness. If the taxpayer sells property which is encumbered by a mortgage or other indebtedness on which the taxpayer is not personally liable, and the person acquiring the property is the obligee, the taxpayer shall be treated as having received payment in the amount of such indebtedness.

(ii) *Wrap-around mortgage.* This paragraph (b)(3)(ii) shall apply generally to any installment sale after March 4, 1981 unless the installment sale was completed before June 1, 1981 pursuant to a written obligation binding on the seller that was executed on or before March 4, 1981. A ''wrap-around mortgage'' means an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property (''wrapped indebtedness'') and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness. The wrapped indebtedness shall be deemed to have been taken subject to even though title to the property has not passed in the year of sale and even though the seller remains liable for payments on the wrapped indebtedness. In the hands of the seller, the wrap-around installment obligation shall have a basis equal to the seller's basis in the property which was the subject of the installment sale, increased by the amount of gain recognized in the year of sale, and decreased by the amount of cash and the fair market value of other nonqualifying property received in the year of sale. For purposes of this paragraph (b)(3)(ii), the amount of any indebtedness assumed or taken subject to by the buyer (other than wrapped indebtedness) is to be treated as cash received by the seller in the year of sale. Therefore, except as otherwise required by section 483 or 1232, the gross profit ratio with respect to the wrap-around installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation.

(iii) *Standby letter of credit.* The term ''standby letter of credit'' means a non-negotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit. Whether or not the letter of credit explicitly states it is non-negotiable and nontransferable, it will be treated as non-negotiable and nontransferable if applicable local law so provides. The mere right of the secured party (under applicable local law) to transfer the proceeds of a letter of credit shall be disregarded in determining whether the instrument qualifies as a standby letter of credit. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

(4) *Exceptions.* The term ''installment sale'' does not include, and the provisions of section 453 do not apply to, dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan, or to dispositions of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year. See section 453A and the regulations thereunder for rules relating to installment sales by dealers in personal property. A dealer in real property or a farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453.

(5) *Examples.* The following examples illustrate installment method reporting under this section:

Example (1). In 1980, A, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in A's hands, to B for $100,000: $10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. A's basis in Blackacre, exclusive of selling expenses, is $38,000. Selling expenses paid by A are $2,000. Therefore, the gross profit is $60,000 ($100,000 selling price − $40,000 basis inclusive of selling expenses). The gross profit ratio is 3/5 (gross profit of $60,000 divided by $100,000 contract price). Accordingly, $6,000 3/5 of $10,000) of each $10,000 payment received is gain attributable to the sale and $4,000 ($10,000 − $6,000) is recovery of basis. The interest received in addition to principal is ordinary income to A.

Example (2). C sells Whiteacre to D for a selling price of $160,000. Whiteacre is encumbered by a longstanding mortgage in the principal amount of $60,000. D will assume or take subject to the $60,000 mortgage and pay the remaining $100,000 in 10 equal annual installments together with adequate stated interest. C's basis in Whiteacre is $90,000. There are no selling expenses. The contract price is $100,000, the $160,000 selling price reduced by the mortgage of $60,000 assumed or taken subject to. Gross profit is $70,000 ($160,000 selling price less C's basis of $90,000). C's gross profit ratio is 7/10 (gross profit of $70,000 divided by $100,000 contract price). Thus, $7,000 (7/10 of $10,000) of each $10,000 annual payment is gain attributable to the sale, and $3,000 ($10,000 − $7,000) is recovery of basis.

Example (3). The facts are the same as in example (2), except that C's basis in the land is $40,000. In the year of the sale C is deemed to have received payment of $20,000 ($60,000 − $40,000, the amount by which the mortgage D assumed or took subject to exceeds C's basis). Since basis is fully recovered in the year of sale, the gross profit ratio is 1 ($120,000/$120,000) and C will report 100% of the $20,000 deemed payment in the year of sale and each $10,000 annual payment as gain attributable to the sale.

Example (4). E sells Blackacre, an unencumbered capital gain property in E's hands, to F on January 2, 1981. F makes a cash down payment of $500,000 and issues a note to E obliging F to pay an additional $500,000 on the fifth anniversary date. The note does not require a payment of interest. In determining selling price, section 483 will apply to recharacterize as interest a portion of the $500,000 future payment. Assume that under section 483 and the applicable regulations $193,045 is treated as total unstated interest, and the selling price is $806,955 ($1 million less unstated interest). Assuming E's basis (including selling expenses) in Blackacre is $200,000) gross profit is $606,955 ($806,955 − $200,000) and the gross profit ratio is 75.21547%. Accordingly, of the $500,000 cash down payment received by E in 1981, $376,077 (75.21547% of $500,000) is gain attributable to the sale and $123,923 is recovery of basis ($500,000 − $376,077).

Example (5). In 1982, G sells to H Blackacre, which is encumbered by a first mortgage with a principal amount of $500,000 and a second mortgage with a principal amount of $400,000, for a selling price of $2 million. G's basis in Blackacre is $700,000. Under the agreement between G and H, passage of title is deferred and H does not assume and purportedly does not take subject to either mortgage in the year of sale. H pays G $200,000 in cash and issues a wrap-around mortgage note with a principal amount of $1,800,000 bearing adequate stated interest. H is deemed to have acquired Blackacre subject to the first and second mortgages (wrapped indebtedness) totalling $900,000. The contract price is $1,300,000 (selling price of $2 million less $700,000 mortgages within the seller's basis assumed or taken subject to). Gross profit is also $1,300,000 (selling price of $2 million less $700,000 basis). Accordingly in the year of sale, the gross profit ratio is 1 ($1,300,000/$1,300,000). Payment in the year of sale is $400,000 ($200,000 cash received plus $200,000 mortgage in excess of basis ($900,000 − $700,000)). Therefore, G recognizes $400,000 gain in the year of sale ($400,000×1). In the hands of G the wrap-around installment obligation has a basis of $900,000, equal to G's basis in Blackacre ($700,000) increased by the gain recognized by G in the year of sale ($400,000) reduced by the cash received by G in the year of sale ($200,000). G's gross profit with respect to the note is $900,000 ($1,800,000 face amount less $900,000 basis in the note) and G's contract price with respect to the note is its face

amount of $1,800,000. Therefore, the gross profit ratio with respect to the note is ½ ($900,000/$1,800,000).

Example (6). The facts are the same as example (5) except that under the terms of the agreement H assumes the $500,000 first mortgage on Blackacre. H does not assume and purportedly does not take subject to the $400,000 second mortgage on Blackacre. The wrap-around installment obligation issued by H to G has a face amount of $1,300,000. The tax results in the year of sale to G are the same as example (5) ($400,000 payment received and gain recognized). In the hands of G, basis in the wrap-around installment obligation is $400,000 ($700,000 basis in Blackacre plus $400,000 gain recognized in the year of sale minus $700,000 ($200,000 cash received and $500,000 treated as cash received as a result of H's assumption of the first mortgage)). G's gross profit with respect to the note is $900,000 ($1,300,000 face amount of the wrap-around installment obligation less $400,000 basis in that note) and G's contract price with respect to the note is its face value of $1,300,000. Therefore, the gross profit ratio with respect to the note is 9/13 ($900,000/$1,300,000).

Example (7). A sells the stock of X corporation to B for a $1 million installment obligation payable in equal annual installments over the next 10 years with adequate stated interest. The installment obligation is secured by a standby letter of credit (within the meaning of paragraph (b)(3)(iii) of this section) issued by M bank. Under the agreement between B and M bank, B is required to maintain a compensating balance in an account B maintains with M bank and is required by the M bank to post additional collateral, which may include cash or a cash equivalent, with M bank. Under neither the standby letter of credit nor any other agreement or arrangement is A granted a direct lien upon or other security interest in such cash or cash equivalent collateral. Receipt of B's installment obligation secured by the standby letter of credit will not be treated as the receipt of payment by A.

Example (8). The facts are the same as in example (7) except that the standby letter of credit is in the drawable sum of $600,000. To secure fully its $1 million note issued to A, B deposits in escrow $400,000 in cash and Treasury bills. Under the escrow agreement, upon default in payment of the note A may look directly to the escrowed collateral. Receipt of B's installment obligation will be treated as the receipt payment by A in the sum of $400,000.

(c) *Contingent payment sales*—(1) *In general.* Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, contingent payment sales are to be reported on the installment method. As used in this section, the term ''contingent payment sale'' means a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs.

The term ''contingent payment sale'' does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term. See paragraph (c)(8) of this section, describing the extent to which the regulations under section 385 apply to the determination of whether an installment obligation represents an equity interest in a corporation.

This paragraph prescribes the rules to be applied in allocating the taxpayer's basis (including selling expenses except for selling expenses of dealers in real estate) to payments received and to be received in a contingent payment sale. The rules are designed appropriately to distinguish contingent payment sales for which a maximum selling price is determinable, sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable. In addition, rules are prescribed under which, in appropriate circumstances, the taxpayer will be permitted to recover basis under an income forecast computation.

(2) *Stated maximum selling price*—(i) *In general.* (A) contingent payment sale will be treated as having a stated maximum selling price if, under the terms of the agreement, the maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. The stated maximum selling price shall be determined by assuming

that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement. Except as provided in paragraph (c)(2)(ii) and (7) of this section (relating to certain payment recomputations), the taxpayer's basis shall be allocated to payments received and to be received under a stated maximum selling price agreement by treating the stated maximum selling price as the selling price for purposes of paragraph (b) of this section. The stated maximum selling price, as initially determined, shall thereafter be treated as the selling price unless and until that maximum amount is reduced, whether pursuant to the terms of the original agreement, by subsequent amendment, by application of the payment recharacterization rule (discribed in paragraph (c)(2)(ii) of this section), or by a subsequent supervening event such as bankruptcy of the obligor. When the maximum amount is subsequently reduced, the gross profit ratio will be recomputed with respect to payments received in or after the taxable year in which an event requiring reduction occurs. If, however, application of the foregoing rules in a particular case would substantially and inappropriately accelerate or defer recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

(B) The following examples illustrate the provisions of paragraph (e)(2)(i) of this section. In each example, it is assumed that application of the rules illustrated will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

Example (1). A sells all of the stock of X corporation to B for $100,000 payable at closing plus an amount equal to 5% of the net profits of X for each of the next nine years, the contingent payments to be made annually together with adequate stated interest. The agreement provides that the maximum amount A may receive, inclusive of the $100,000 down payment but exclusive of interest, shall be $2,000,000. A's basis in the stock of X inclusive of selling expenses, is $200,000. Selling price and contract price are considered to be $2,000,000. Gross profit is $1,800,000, and the gross profit ratio is 9/10 ($1,800,000/$2,000,000). Accordingly, of the $100,000 received by A in the year of sale, $90,000 is reportable as gain attributable to the sale and $10,000 is recovery of basis.

Example (2). C owns Blackacre which is encumbered by a long-standing mortgage of $100,000. On January 15, 1981, C sells Blackacre to D under the following payment arrangement: $100,000 in cash on closing; nine equal annual installment payments of $100,000 commencing January 15, 1982; and nine annual payments (the first to be made on March 30, 1982) equal to 5% of the gross annual rental receipts from Blackacre generated during the preceding calendar year. The agreement provides that each deferred payment shall be accompanied by a payment of interest calculated at the rate of 12% per annum and that the maximum amount payable to C under the agreement (exclusive of interest) shall be $2,100,000. The agreement also specifies that D will assume the long-standing mortgage. C's basis (inclusive of selling expenses) in Blackacre is $300,000. Accordingly, selling price is $2,100,000 and contract price is $2,000,000 (selling price of $2,100,000 less the $100,000 mortgage). The gross profit ratio is 9/10 (gross profit of $1,800,000 divided by $2,000,000 contract price). Of the $100,000 cash payment received by C in 1981, $90,000 is gain attributable to the sale of Blackacre and $10,000 is recovery of basis.

(ii) *Certain interest recomputations.* When interest is stated in the contingent price sale agreement at a rate equal to or greater than the applicable prescribed test rate referred to in § 1.483–1(d)(1)(ii) and such stated interest is payable in addition to the amounts otherwise payable under the agreement, such stated interest is not considered a part of the selling price. In other circumstances (*i.e.*, section 483 is applicable because no interest is stated or interest is stated below the applicable test rate, or interest is stated under a payment recharacterization provision of the sale agreement), the special rule set forth in this (ii) shall be applied in the initial computation and subsequent recomputations of selling price, contract price, and gross profit ratio. The special rule is referred to in this section as the ''price-interest recomputation rule.'' As used in this section, the term ''payment recharacterization'' refers to a contractual arrangement under which a computed amount otherwise payable as part of the selling price is denominated an interest payment. The amount of unstated interest determined under

section 483 or (if section 483 is inapplicable in the particular case) the amount of interest determined under a payment recharacterization arrangement is collectively referred to in this section as ''internal interest'' amounts. The price-interest recomputation rule is applicable to any stated maximum selling price agreement which contemplates receipt of internal interest by the taxpayer. Under the rule, stated maximum selling price will be determined as of the end of the taxpayer's taxable year in which the sale or other disposition occurs, taking into account all events which have occurred and are subject to prompt subsequent calculation and verification and assuming that all amounts that may become payable under the agreement will be paid on the earliest date or dates permitted under the agreement. With respect to the year of sale, the amount (if any) of internal interest then shall be determined taking account of the respective components of that calculation. The maximum amount initially calculated, minus the internal interest so determined, is the initial stated maximum selling price under the price-interest recomputation rule. For each subsequent taxable year, stated maximum selling price (and thus selling price, contract price, and gross profit ratio) shall be recomputed, taking into account all events which have occurred and are subject to prompt subsequent calculation and verification and assuming that all amounts that may become payable under the agreement will be paid on the earliest date or dates permitted under the agreement. The redetermined gross profit ratio, adjusted to reflect payments received and gain recognized in prior taxable years, shall be applied to payments received in that taxable year.

(iii) *Examples.* The following examples illustrate installment method reporting of a contingent payment sale under which there is a stated maximum selling price. In each example, it is assumed that application of the rules described will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

Example (1). A owns all of the stock of X corporation with a basis to A of $20 million. On July 1, 1981, A sells the stock of X to B under an agreement calling for fifteen annual payments respectively equal to 5% of the net profits of X earned in the immediately preceding fiscal year beginning with the fiscal year ending March 31, 1982. Each payment is to be made on the following June 15th, commencing June 15, 1982, together with adequate stated interest. The agreement specifies that the maximum amount (exclusive of interest) payable to A shall not exceed $60 million. Since stated interest is payable as an addition to the selling price and the specified rate is not below the section 483 test rate, there is no internal interest under the agreement. The stated maximum selling price is $60 million. The gross profit ratio is ⅔ (gross profit of $40 million divided by $60 million contract price). Thus, if on June 15, 1982, A receives a payment of $3 million (exclusive of interest) under the agreement, in that year A will report $2 million ($3 million × ⅔) as gain attributable to the sale, and $1 million as recovery of basis.

Example (2). (i) The facts are the same as in example (1) except that the agreement does not call for the payment of any stated interest but does provide for an initial cash payment of $3 million on July 1, 1981. The maximum amount payable, including the $3 million initial payment, remains $60 million. Since section 483 will apply to each payment received by A more than one year following the date of sale (section 483 is inapplicable to the contingent payment that will be received on June 15, 1982 since that date is within one year following the July 1, 1981 sale date), the agreement contemplates internal interest and the price-interest recomputation rule is applicable. Under the rule, an initial determination must be made for A's taxable year 1981. On December 31, 1981, the last day of the taxable year, no events with regard to the first fiscal year have occurred which are subject to prompt subsequent calculation and verification because that fiscal year will end March 31, 1982. Under the price-interest recomputation rule, on December 31, 1981 A is required to assume that the maximum amount subsequently payable under the agreement ($57 million, equal to $60 million less the $3 million initial cash payment received by A in 1981) will be paid on the earliest date permissible under the agreement, *i.e.*, on June 15, 1982. Since no part of a payment received on that date would be treated as interest under section 483, the initial stated maximum selling price, applicable to A's 1981 tax calculations, is deemed to be $60 million. Thus, the 1981 gross profit ratio is ⅔ and for the taxable year 1981 A will report $2 million as gain attributable to the sale.

(ii) The net profits of X for its fiscal year ending March 31, 1982 are $120 million. On June 15, 1982 A receives a payment from B equal to 5% of that amount, or $6 million. On December 31, 1982, A knows that the maximum amount he may subsequently receive

under the agreement is $51 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1983. Section 483 does not treat as interest any part of the $6 million received by A on June 15, 1982, but section 483 will treat as unstated interest a computed part of the $51 million it is assumed A will receive on June 15, 1983. Assuming that under the tables in the regulations under section 483, it is determined that the principal component of a payment received more than 21 months but less than 27 months after the date of sale is considered to be .82270, $41,957,700 of the presumed $51 million payment will be treated as principal. The balance of $9,042,300 is interest. Accordingly, in A's 1982 tax calculations stated maximum selling price will be $50,957,700, which amount is equal to the stated maximum selling price that was determined in the 1981 tax calculations ($60 million) reduced by the section 483 interest component of the $6 million payment received by A in 1982 ($0) and further reduced by the section 483 interest component of the $51 million presumed payment to be received by A on June 15, 1983 ($9,042,300). Similarly, in determining gross profit for 1982 tax calculations, the gross profit of $40 million determined in the 1981 tax calculations must be reduced by the same section 483 interest amounts, yielding a recomputed gross profit of $30,957,700 ($40,000,000–$9,042,300). Further, since prior to 1982 A received payment under the agreement (1981 payment of $3 million of which $2 million was profit), the appropriate amounts must be subtracted in the 1982 tax calculation. The total previously received selling price payment of $3 million is subtracted from the recomputed maximum selling price of $50,957,700, yielding an adjusted selling price of $47,957,700. The total previously recognized gain of $2 million is subtracted from the recomputed maximum gross profit of $30,957,700, yielding an adjusted gross profit of $28,957,700. The gross profit percentage applicable to 1982 tax calculations thus is determined to be 60.38175%, equal to the quotient of dividing the adjusted gross profit of $28,957,700 by the adjusted selling price of $47,957,700. Accordingly, of the $6 million received by A in 1982, no part of which is unstated interest under section 483, A will report $3,622,905 (60.38175% of $6 million) as gain attributable to the sale and $2,377,095 ($6,000,000–$3,622,905) as recovery of basis.

(iii) The net profits of X for its fiscal year ending March 31, 1983 are $200 million. On June 15, 1983 A receives a payment from B equal to $10 million. On December 31, 1983, A knows that the maximum amount he may subsequently receive under the agreement is $41 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1984. Assuming that under the tables in the regulations under section 483 it is determined that the principal component of a payment received more than 33 months but less than 39 months after the date of sale is .74622, $30,595,020 of the presumed $41 million ($51 million–$10 million) payment will be treated as principal and $10,404,980 is interest. Based upon the assumed factor for 21 months but less than 27 months (.82270) $8,227,000 of the $10 million payment is principal and $1,773,000 is interest. Accordingly, in A's 1983 tax calculations stated maximum selling price will be $47,822,020, which amount is equal to the stated maximum selling price determined in the 1981 calculation ($60 million) reduced by the section 483 interest component of the $6 million 1982 payment ($0), the section 483 interest component of the 1983 payment ($1,773,000) and by the section 483 interest component of the presumed $41 million payment to be received in 1984 ($10,404,980). The recomputed gross profit is $27,822,020 ($40 million–$10,404,980–$1,773,000). The previously reported payments must be deducted for the 1983 calculation. Selling price is reduced to $38,822,020 by subtracting the $3 million 1981 payment and the $6 million 1982 payment ($47,822,020–$9 million) and gross profit is reduced to $22,199,115 by subtracting the 1981 profit of $2 million and the 1982 profit of $3,622,905 ($27,822,020–$5,622,905), yielding a gross profit percentage of 57.18176% ($22,199,115/$38,822,020). Accordingly, of the $10 million received in 1983, A will report $1,773,000 as interest under section 483, and of the remaining principal component of $8,227,000, $4,704,343 as gain attributable to the sale ($8,227,000×57.18176%) and $3,522,657 ($8,227,000–$4,704,343) as recovery of basis.

Example (3). The facts are the same as in example (2) except that X is a collapsible corporation as defined in section 341(b)(1) and no limitation or exception under section 341 (d), (e), or (f) is applicable. Under section 341(a), all of A's gain on the sale will be ordinary income. Accordingly, section 483 will not apply to treat as interest any part of the payments to be received by A under his agreement with B. See section 483(f)(3). Therefore, the price-interest recomputation rule is inapplicable and the tax results to A in each year in which payment is received will be determined in a manner consistent with example (1).

Example (4). The facts are the same as in example (2) (maximum amount payable under the agreement $60 million) except that the agreement between A and B contains the following ''payment recharacterization'' provision:

''Any payment made more than one year after the (July 1, 1981) date of sale shall be composed of an interest element and a principal element, the interest element being

computed on the principal element at an interest rate of 9% per annum computed from the date of sale to the date of payment.''

The results reached in example (2), with respect to the $3 million initial cash payment received by A in 1981 remain the same because, under the payment recharacterization formula, no amount received or assumed to be received prior to July 1, 1982 is treated as interest. The 1982 tax computation method described in example (2) is equally applicable to the $6 million payment received in 1982. However, the adjusted gross profit ratio determined in this example (4) will differ from the ratio determined in example (2). The difference is attributable to the difference between a 9% stated interest rate calculation (in this example (4)) and the compound rate of unstated interest required under section 483 and used in calculating the results in example (2).

Example (5). The facts are the same as in example (1). In 1992 X is adjudged a bankrupt and it is determined that, in and after 1992, B will not be required to make any further payments under the agreement, *i.e.*, B's contingent payment obligation held by A now has become worthless. Assume that A previously received aggregate payments (exclusive of interest) of $45 million and out of those payments recovered $15 million of A's total $20 million basis. For 1992 A will report a loss of $5 million attributable to the sale, taken at the time determined to be appropriate under the rules generally applicable to worthless debts.

Example (6). (i) C owns all of the stock of Z corporation, a calendar year taxpayer. On July 1, 1981, C sells the stock of Z to D under an agreement calling for payment, each year for the next ten years, of an amount equal to 10% of the net profits of Z earned in the immediately preceding calendar year beginning with the year ending December 31, 1981. Each payment is to be made on the following April 1st, commencing April 1, 1982. In addition, C is to receive a payment of $5 million on closing. The agreement specifies that the maximum amount payable to C, including the $5 million cash payment at closing, is $24 million. The agreement does not call for the payment of any stated interest. Since section 483 will apply to each payment received by C more than one year following the date of sale (section 483 is inapplicable to the payment that will be received on April 1, 1982, since that date is within one year following the July 1, 1981 sale date), the agreement contemplates internal interest and the price interest recomputation rule is applicable. Under that rule, C must make an initial determination for his taxable year 1981.

(ii) On December 31, 1981, the exact amount of Z's 1981 net profit is not known, since it normally takes a number of weeks to compile the relevant information. However, the events which will determine the amount of the payment C will receive on April 1, 1982 have already occurred, and the information (Z's 1981 financial statement) will be promptly calculated and verified and will be available prior to the time C's 1981 tax return is timely filed. On March 15, 1982, Z reports net income of $14 million, and on April 1, 1982 D pays C $1.4 million.

(iii) Under the price-interest recomputation rule, C is required to determine the gross profit ratio for the 1981 $5 million payment on the basis of the events which occurred by the close of that taxable year and which are verifiable before the due date of the 1981 return. Because at the end of C's 1981 taxable year all events which will determine the amount of the April 1, 1982 payment have occurred and because the actual facts are known prior to the due date of C's return, C will take those facts into account when calculating the gross profit ratio. Thus, because C knows that the 1982 payment is $1.4 million, C knows that the remaining amount to be recovered under the contract is $17.6 million ($24 million − ($5 million + $1.4 million)). For purposes of this paragraph C must assume that the entire $17.6 million will be paid on the earliest possible date, April 1, 1983. Because section 483 will apply to that payment, and assuming that under the tables in the regulations under section 483 the principal component of a payment received 21 months after the date of sale is considered to be .86384, $15,203,584 of the $17.6 million would be principal and $2,396,416 ($17,600,000 − $15,203,584) would be interest. Therefore, C must assume, for purposes of reporting the $5 million payment received in 1981, that the selling price is $21,603,584 calculated as follows:

Total selling price	$24,000,000
Interest component of the $17,600,000 payment which C must assume will be made April 1, 1983	−2,396,416
Adjusted selling price to be used when reporting the 1981 payment	21,603,584

(iv) Assume that on March 15, 1982, Z reports net income of $15 million for 1982 and that on April 1, 1983 D pays C $1.5 million. Because section 483 will apply to that payment, and assuming that under the tables in the regulations under section 483 the principal component of a payment received 21 months after the date of sale is considered to be .86384, $1,295,760 of the $1,500,000 payment will be principal and $204,240 ($1,500,000 − $1,295,760) will be interest. Because C knows the amount of the 1983 payment when filing the 1982 tax return, C must assume that the remaining amount to be received under the contract, $16.1 million ($24 million − ($5 million + $1.4 million + $1.5 million)), will be received as a lump sum on April 1, 1984. Because section 483 will again apply, and assuming that the principal component of a

payment made 34 months after the date of the sale is .74622, $12,014,142 of the $16.1 million would be principal, and $4,085,858 ($16,100,000 − $12,014,142) would be interest. Therefore, C must assume, for purpose of reporting the $1.4 million payment made April 1, 1982, that the adjusted selling price (within the meaning of example (2)) is $14,709,902, calculated as follows:

Total selling price	$24,000,000
Interest component of the $1,500,000 payment made April 1, 1983	−204,240
Interest component of the $16,100,000 payment which C must assume will be made April 1, 1984	−4,085,858
Payment made in 1981	−5,000,000
Adjusted selling price for calculations for reporting the 1982 payment	14,709,902

(3) *Fixed period*—(i) *In general.* When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. In making the allocation it is not relevant whether the buyer is required to pay adequate stated interest. However, if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to accord with the variable component. If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless. When no loss is allowed, the unrecovered portion of basis allocated to the taxable year shall be carried forward to the next succeeding taxable year. If application of the foregoing rules to a particular case would substantially and inappropriately defer or accelerate recovery of the taxpayer's basis, a special rule will apply. See paragraph (c)(7) of this section.

(ii) *Examples.* The following examples illustrate the rules for recovery of basis in a contingent payment sale in which stated maximum selling price cannot be determined but the period over which payments are to be received under the agreement is fixed. In each case, it is assumed that application of the described rules will not substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

Example (1). A sells Blackacre to B for 10 percent of Blackacre's gross yield for each of the next 5 years. A's basis in Blackacre is $5 million. Since the sales price is indefinite and the maximum selling price is not ascertainable from the terms of the contract, basis is recovered ratably over the period during which payment may be received under the contract. Thus, assuming A receives the payments (exclusive of interest) listed in the following table, A will report the following:

Year	Payment	Basis recovered	Gain attributable to the sale
1	$1,300,000	$1,000,000	$300,000
2	1,500,000	1,000,000	500,000
3	1,400,000	1,000,000	400,000
4	1,800,000	1,000,000	800,000
5	2,100,000	1,000,000	1,100,000

Example (2). The facts are the same as in example (1), except that the payment in year 1 is only $900,000. Since the installment payment is less than the amount of basis allocated to that year, the unrecovered basis, $100,000, is carried forward to year 2.

Year	Payment	Basis recovered	Gain attributable to the sale
1	$900,000	$900,000	.....
2	1,500,000	1,100,000	$400,000
3	1,400,000	1,000,000	400,000
4	1,800,000	1,000,000	800,000
5	2,100,000	1,000,000	1,100,000

Example (3). C owns all of the stock of X corporation with a basis of $100,000 (inclusive of selling expenses). D purchases the X stock from C and agrees to make four payments computed in accordance with the following formula: 40% of the net profits of X in year 1, 30% in year 2, 20% in year 3, and 10% in year 4. Accordingly, C's basis is allocated as

follows: $40,000 to year 1, $30,000 to year 2, $20,000 to year 3, and $10,000 to year 4.

Example (4). The facts are the same as in example (3), but the agreement also requires that D make fixed installment payments in accordance with the following schedule: no payment in year 1, $100,000 in year 2, $200,000 in year 3, $300,000 in year 4, and $400,000 in year 5. Thus, while it is reasonable to project that the contingent component of the payments will decrease each year, the fixed component of the payments will increase each year. Accordingly, C is required to allocate $20,000 of basis to each of the taxable years 1 through 5.

(4) *Neither stated maximum selling price nor fixed period.* If the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received under the agreement are in the nature of rent or royalty income. Arrangements of this sort will be closely scrutinized. If, taking into account all of the pertinent facts, including the nature of the property, the arrangement is determined to qualify as a sale, the taxpayer's basis (including selling expenses) shall be recovered in equal annual increments over a period of 15 years commencing with the date of sale. However, if in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than basis allocated to the year, no loss shall be allowed unless it is otherwise determined in accordance with the timing rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless; instead the excess basis shall be reallocated in level amounts over the balance of the 15 year term. Any basis not recovered at the end of the 15th year shall be carried forward to the next succeeding year, and to the extent unrecovered thereafter shall be carried forward from year to year until all basis has been recovered or the future payment obligation is determined to be worthless. The general rule requiring initial level allocation of basis over 15 years shall not apply if the taxpayer can establish to the satisfaction of the Internal Revenue Service that application of the general rule would substantially and inappropriately defer recovery of the taxpayer's basis. See paragraph (c)(7) of this section. If the Service determines that initially allocating basis in level amounts over the first 15 years will substantially and inappropriately accelerate recovery of the taxpayer's basis in early years of that 15-year term, the Service may require that basis be reallocated within the 15-year term but the Service will not require that basis initially be allocated over more than 15 years. See paragraph (c)(7) of this section.

(5) *Foreign currency and other fungible payment units*—(i) *In general.* An installment sale may call for payment in foreign currency. For federal income tax purposes, foreign currency is property. Because the value of foreign currency will vary over time in relation to the United States dollar, an installment sale requiring payment in foreign currency is a contingent payment sale. However, when the consideration payable under an installment sale agreement is specified in foreign currency, the taxpayer's basis (including selling expenses) shall be recovered in the same manner as basis would have been recovered had the agreement called for payment in United States dollars. This rule is equally applicable to any installment sale in which the agreement specifies that payment shall be made in identified, fungible units of property the value of which will or may vary over time in relation to the dollar (*e.g.*, bushels of wheat or ounces of gold).

(ii) *Example.* The following example illustrates the provisions of this subparagraph:

Example. A sells Blackacre to B for 4 million Swiss francs payable 1 million in year 2 and 3 million in year 3, together with adequate stated interest. A's basis (including selling expenses) in Blackacre is $100,000. Twenty five thousand dollars of A's basis (¼ of total basis) is allocable to the year 2 payment of 1 million Swiss francs and $75,000 of A's basis is allocable to the year 3 payment of 3 million Swiss francs.

(6) *Income forecast method for basis recovery*—(i) *In general.* The rules for ratable recovery of basis set forth in paragraph (c) (2) through (4) of this section focus on the payment terms of the contingent selling price agreement. Except to the extent contemplated by paragraph(c)(7) of this section (relating to a

special rule to prevent substantial distortion of basis recovery), the nature and productivity of the property sold is not independently relevant to the basis to be recovered in any payment year. The special rule for an income forecast method of basis recovery set forth in paragraph (c)(6) of this section recognizes that there are cases in which failure to take account of the nature or productivity of the property sold may be expected to result in distortion of the taxpayer's income over time. Specifically, when the property sold is depreciable property of a type normally eligible for depreciation on the income forecast method, or is depletable property of a type normally eligible for cost depletion in which total future production must be estimated, and payments under the contingent selling price agreement are based upon receipts or units produced by or from the property, the taxpayer's basis may appropriately be recovered by using an income forecast method.

(ii) *Availability of method.* In lieu of applying the rules set forth in paragraph (c) (2) through (4) of this section, in an appropriate case the taxpayer may elect (on its tax return timely filed for the first year under the contingent payment agreement in which a payment is received) to recover basis using the income forecast method of basis recovery. No special form of election is prescribed. An appropriate case is one meeting the criteria set forth in paragraph (c)(6)(i) of this section in which the property sold is a mineral property, a motion picture film, a television film, or a taped television show. The Internal Revenue Service may from time to time specify other properties of a similar character which, in appropriate circumstances, will be eligible for recovery of basis on the income forecast method. In addition, a taxpayer may seek a ruling from the Service as to whether a specific property qualifies as property of a similar character eligible, in appropriate circumstances, for income forecast recovery of basis.

(iii) *Required calculations.* The income forecast method requires application of a fraction, the numerator of which is the payment (exclusive of interest) received in the taxable year under a contingent payment agreement, and the denominator of which is the forecast or estimated total payments (exclusive of interest) to be received under the agreement. This fraction is multiplied by the taxpayer's basis in the property sold to determine the basis recovered with respect to the payment received in the taxable year. If in a subsequent year it is found that the income forecast was substantially overestimated or underestimated by reason of circumstances occurring in such subsequent year, an adjustment of the income forecast of such subsequent year shall be made. In such case, the formula for computing recovery of basis would be as follows: payment received in the taxable year (exclusive of interest) divided by the revised estimated total payments (exclusive of interest) then and thereafter to be made under the agreement (the current year's payment and total estimated future payments), multiplied by the taxpayer's unrecovered basis remaining as of the beginning of the taxable year. If the agreement contemplates internal interest (as defined in paragraph (c)(2)(ii) of this section), in making the initial income forecast computation and in making any required subsequent recomputation the amount of internal interest (which shall not be treated as payment under the agreement) shall be calculated by assuming that each future contingent selling price payment will be made in the amount and at the time forecast. The total forecast of estimated payments to be received under the agreement shall be based on the conditions known to exist at the end of the taxable year for which the return is filed. If a subsequent upward or downward revision of this estimate is required, the revision shall be made at the end of the subsequent taxable year based on additional information which became available after the last prior estimate. No loss shall be allowed unless the taxable year is the final payment year under the agreement or unless it is otherwise determined in accordance with the rules generally applicable to the time a debt becomes worthless that the future payment obligation under the agreement has become worthless.

(iv) *Examples.* The following examples illustrate the income forecast method of basis recovery:

Example (1). A sells a television film to B for 5% of annual gross receipts from the exploitation of the film. The film is an ordinary income asset in the hands of A. A reasonably forecasts that total payments to be received under the contingent selling price agreement will be $1,200,000, and that A will be paid $600,000 in year 1, $150,000 in year 2, $300,000 in year 3, $100,000 in year 4, and $50,000 in year 5. A reasonably anticipates no or only insignificant receipts thereafter. A's basis in the film is $100,000. Under the income forecast method, A's basis initially is allocated to the five taxable years of forecasted payment as follows:

Year	Percentage	Basis
1	50.00	$50,000
2	12.50	12,500
3	25.00	25,000
4	8.33	8,333
5	4.17	4,167

Payments are received and A reports the sale under the installment method as follows:

Year	Payment received	Basis recovered	Gain on sale
1	$600,000	$50,000	$550,000
2	150,000	12,500	137,500
3	300,000	25,000	275,000
4	100,000	8,333	91,667
5	50,000	4,167	45,833

Example (2). The facts are the same as in example (1), except that in year 2 A receives no payment. In year 3 A receives a payment of $300,000 and reasonably estimates that in subsequent years he will receive total additional payments of only $100,000. In year 2 A will be allowed no loss. At the beginning of year 3 A's unrecovered basis is $50,000. In year 3 A must recompute the applicable basis recovery fraction based upon facts known and forecast as at the end of year 3: year 3 payment of $300,000 divided by estimated current and future payments of $400,000, equaling 75%. Thus, in year 3 A recovers $37,500 (75% of $50,000) of A's previously unrecovered basis.

(7) *Special rule to avoid substantial distortion*—(i) *In general.* The normal basis recovery rules set forth in paragraph (c) (2) through (4) of this section may, with respect to a particular contingent payment sale, substantially and inappropriately defer or accelerate recovery of the taxpayer's basis.

(ii) *Substantial and inappropriate deferral.* The taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis and, (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery described in paragraph (c)(7)(ii) of this section.

The request for a ruling shall be made in accordance with all applicable procedural rules set forth in the Statement of Procedural Rules (26 CFR part 601) and any applicable revenue procedures relating to submission of ruling requests. The request shall be submitted to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, DC 20224. The taxpayer must file a request for a ruling prior to the due date for the return including extensions. In demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis, the taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profit, or other factual data that are subject to verification. The taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits, or the like. However, in special circumstances a reasonable projection may be acceptable if the projection is based upon a specific event that already has occurred (*e.g.*, corporate stock has been sold for future payments contingent on profits and an inadequately insured major plant facility of the corporation has been destroyed).

(iii) *Substantial and inappropriate acceleration.* Notwithstanding the other provisions of this paragraph, the Internal Revenue Service may find that the normal basis recovery rule will substantially and inappropriately accelerate recovery of basis. In such a case, the Service may require an alternate method of basis recovery, unless the taxpayer is able to demonstrate either (A) that the method of basis recovery required by the Service is not a reasonable method of ratable recovery, or (B) that it is not reasonable to conclude that the taxpayer over time is likely to recover basis at a rate twice as fast under the normally applicable basis recovery rule as the rate at which basis would be recovered under the method proposed by the Service. In making such demonstrations the taxpayer may rely in appropriate circumstances upon contemporaneous or immediate past relevant sales, profit, or other factual data subject to verification. In special circumstances a reasonable projection may be acceptable, but only with the consent of the Service, if the projection is based upon a specific event that has already occurred.

(iv) *Subsequent recomputation.* A contingent payment sale may initially and properly have been reported under the normally applicable basis recovery rule and, during the term of the agreement, circumstances may show that continued reporting on the original method will substantially and inappropriately defer or accelerate recovery of the unrecovered balance of the taxpayer's basis. In this event, the special rule provided in this paragraph is applicable.

(v) *Examples.* The following examples illustrate the application of the special rule of this paragraph. In examples (1) and (2) it is assumed that rulings consistent with paragraph (c)(7)(ii) of this section have been requested.

Example (1). A owns all of the stock of X corporation with a basis of $100,000. A sells the stock of X to B for a cash down payment of $1,800,000 and B's agreement to pay A an amount equal to 1% of the net profits of X in each of the next 10 years (together with adequate stated interest). The agreement further specifies that the maximum amount that may be paid to A (exclusive of interest) shall not exceed $10 million. A is able to demonstrate that current and recent profits of X have approximated $2 million annually, and that there is no reason to anticipate a major increase in the annual profits of X during the next 10 years. One percent of $2 million annual profits is $20,000, a total of $200,000 over 10 years. Under the basis recovery rule normally applicable to a maximum contingent selling price agreement, in the year of sale A would recover $18,000 of A's total $100,000 basis, and would not recover more than a minor part of the balance until the final year under the agreement. On a $2 million selling price ($200,000 plus $1,800,000 down payment), A would recover $90,000 of A's total $100,000 basis in the year of sale and 5% of each payment ($100,000/$2,000,000) received up to a maximum of $10,000 over the next ten years. Since the rate of basis recovery under the demonstrated method is more than twice the rate under the normal rule, A will be permitted to recover $90,000 basis in the year of sale.

Example (2). The facts are the same as in example (1) except that no maximum contingent selling price is stated in the agreement. Under the basis recovery rule normally applicable when no maximum amount is stated but the payment term is fixed, in the year of sale and in each subsequent year A would recover approximately $9,100 (1/11 of $100,000) of A's total basis. A will be permitted to recover $90,000 of A's total basis in the year of sale.

Example (3). The facts are the same as in example (1) except that A sells the X stock to B on the following terms: 1% of the annual net profits of X in each of the next 10 years and a cash payment of $1,800,000 in the eleventh year, all payments to be made together with adequate stated interest. No maximum contingent selling price is stated. Under the normally applicable basis recovery rule, A would recover 1/11 of A's total $100,000 basis in each of the 11 payment years under the agreement. On the facts (see example (1)), A cannot demonstrate that application of the normal rule would not substantially and inappropriately accelerate recovery of A's basis. Accordingly, A will be allowed to recover only $1,000 of A's total basis in each of the 10 contingent payment years under the agreement, and will recover the $90,000 balance of A's basis in the final year in which the large fixed cash payment will be made.

(8) *Coordination with regulations under section 385.* (i) *In general.* The regulations under section 385 do not apply to an instrument (as defined in § 1.385–3(c)) providing for a contingent payment of principal (with or without stated interest) issued in connection with a sale or

other disposition of property to a corporation if § 1.385–6 (relating to proportionality) does not apply to such instrument (or to a class of instruments which includes such instrument). Thus, such instrument will be treated as stock or indebtedness under applicable principles of law without reference to the regulations under section 385.

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

Example (1). On January 1, 1982, corporation X buys a factory from Y, an independent creditor (within the meaning of § 1.385–6(b)). In exchange for the factory, Y receives $200,000 in cash on January 1, 1982. In addition, on January 1, 1984, Y will receive a payment in the range of $100,000 to $300,000, plus adequate stated interest, depending on the factory's output. Based on these facts, § 1.385–6 does not apply to X's obligation to Y (see § 1.385–6(a)(3)(ii)) and the regulations under section 385 doe not apply to X's obligation to Y.

Example (2). The facts are the same as in example (1), except that the contingent payment due on January 1, 1984 will be in the range of $50,000 to $250,000. In addition, on January 1, 1982, Y receives a $50,000 non-interest-bearing note due absolutely and unconditionally on January 1, 1984. Based on these facts, the $50,000 note is treated as stock or indebtedness under the regulations under section 385.

(d) *Election not to report an installment sale on the installment method*—(1) *In general.* An installment sale is to be reported on the installment method unless the taxpayer elects otherwise in accordance with the rules set forth in paragraph (d)(3) of this section.

(2) *Treatment of an installment sale when a taxpayer elects not to report on the installment method*—(i) *In general.* A taxpayer who elects not to report an installment sale on the installment method must recognize gain on the sale in accordance with the taxpayer's method of accounting. The fair market value of an installment obligation shall be determined in accordance with paragraph (d)(2) (ii) and (iii) of this section. In making such determination, any provision of contract or local law restricting the transferability of the installment obligation shall be disregarded. Receipt of an installment obligation shall be treated as a receipt of property, in an amount equal to the fair market value of the installment obligation, whether or not such obligation is the equivalent of cash. An installment obligation is considered to be property and is subject to valuation, as provided in paragraph (d)(2) (ii) and (iii) of this section, without regard to whether the obligation is embodied in a note, an executory contract, or any other instrument, or is an oral promise enforceable under local law.

(ii) *Fixed amount obligations.* (A) A fixed amount obligation means an installment obligation the amount payable under which is fixed. Solely for the purpose of determining whether the amount payable under an installment obligation is fixed, the provisions of section 483 and any ''payment recharacterization'' arrangement (as defined in paragraph (c)(2)(ii) of this section) shall be disregarded. If the fixed amount payable is stated in identified, fungible units of property the value of which will or may vary over time in relation to the United States dollar (*e.g.*, foreign currency, ounces of gold, or bushels of wheat), such units shall be converted to United States dollars at the rate of exchange or dollar value on the date the installment sale is made. A taxpayer using the cash receipts and disbursements methods of accounting shall treat as an amount realized in the year of sale the fair market value of the installment obligation. In no event will the fair market value of the installment obligation be considered to be less than the fair market value of the property sold (minus any other consideration received by the taxpayer on the sale). A taxpayer using the accrual method of accounting shall treat as an amount realized in the year of sale the total amount payable under the installment obligation. For this purpose, neither interest (whether stated or unstated) nor original issue discount is considered to be part of the amount payable. If the amount payable is otherwise fixed, but because the time over which payments may be made is contingent, a portion of the fixed amount will or may be treated as internal interest (as defined in paragraph (c)(2)(ii) of this section), the amount payable shall be determined by applying the price interest recomputation rule (described in paragraph (c)(2)(ii) of this section). Under no circumstances

will an installment sale for a fixed amount obligation be considered an ''open'' transaction. For purposes of this (ii), remote or incidential contingencies are not to be taken into account.

(B) The following examples illustrate the provisions of paragraph (d)(2) of this section.

Example (1). A, an accrual method taxpayer, owns all of the stock of X corporation with a basis of $20 million. On July 1, 1981, A sells the stock of X corporation to B for $60 million payable on June 15, 1992. The agreement also provides that against this fixed amount, B shall make annual prepayments (on June 15) equal to 5% of the net profits of X earned in the immediately preceding fiscal year beginning with the fiscal year ending March 31, 1982. Thus the first prepayment will be made on June 15, 1982. No stated interest is payable under the agreement and thus the unstated interest provisions of section 483 are applicable. Under section 483, no part of any payment made on June 15, 1982 (which is within one year following the July 1, 1981 sale date), will be treated as unstated interest. Under the price interest recomputation rule, it is presumed that the entire $60 million fixed amount will be paid on June 15, 1982. Accordingly, if A elects not to report the transaction on the installment method, in 1981 A must report $60 million as the amount realized on the sale and must report $40 million as gain on the sale in that year.

Example (2). The facts are the same as in example (1) except that A uses the cash receipts and disbursements method of accounting. In 1981 A must report as an amount realized on the sale the fair market value of the installment obligation and must report as gain on the sale in 1981 the excess of that amount realized over A's basis of $20 million. In no event will the fair market value of the installment obligation be considered to be less than the fair market value of the stock of X. In determining the fair market value of the installment obligation, any contractual or legal restrictions on the transferability of the installment obligation, and any remote or incidental contingencies otherwise affecting the amount payable or time of payments under the installment obligation, shall be disregarded.

(iii) *Contingent payment obligations.* Any installment obligation which is not a fixed amount obligation (as defined in paragraph (d)(2)(ii) of this section) is a contingent payment obligation. If an installment obligation contains both a fixed amount component and a contingent payment component, the fixed amount component shall be treated under the rules of paragraph (d)(2)(ii) of this section and the contingent amount component shall be treated under the rules of this (iii). The fair market value of a contingent payment obligation shall be determined by disregarding any restrictions on transfer imposed by agreement or under local law. The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale). Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation (determinable under the preceding sentences) cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is ''open.'' Any such transaction will be carefully scrutinized to determine whether a sale in fact has taken place. A taxpayer using the cash receipts and disbursements method of accounting must report as an amount realized in the year of sale the fair market value of the contingent payment obligation. A taxpayer using the accrual method of accounting must report an amount realized in the year of sale determined in accordance with that method of accounting, but in no event less than the fair market value of the contingent payment obligation.

(3) *Time and manner for making election*—(i) *In general.* An election under paragraph (d)(1) of this section must be made on or before the due date prescribed by law (including extensions) for filing the taxpayer's return for the taxable year in which the installment sale occurs. The election must be made in the manner prescribed by the appropriate forms for the taxpayer's return for the taxable year of the sale. A taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurs will be considered to have made an effective election under paragraph (d)(1) of this section. A cash method taxpayer receiving an obligation the fair market value of which is less than the face value must make the

election in the manner prescribed by appropriate instructions for the return filed for the taxable year of the sale.

(ii) *Election made after the due date.* Elections after the time specified in paragraph (d)(3)(i) of this section will be permitted only in those rare circumstances when the Internal Revenue Service concludes that the taxpayer had good cause for failing to make a timely election. A recharacterization of a transaction as a sale in a taxable year subsequent to the taxable year in which the transaction occurred (*e.g.,* a transaction initially reported as a lease later is determined to have been an installment sale) will not justify a late election. No conditional elections will be permitted. For a special transitional rule relating to certain taxable years for which a return is filed prior to February 19, 1981, see paragraph (d)(5) of this section.

(4) *Revoking an election.* Generally, an election made under paragraph (d)(1) is irrevocable. An election may be revoked only with the consent of the Internal Revenue Service. A revocation is retroactive. A revocation will not be permitted when one of its purposes is the avoidance of Federal income taxes, or when the taxable year in which any payment was received has closed. For a special transitional rule relating to certain taxable years for which a return is filed prior to February 19, 1981, see paragraph (d)(5) of this section.

(5) *Transitional rules.* The following transitional rules shall apply with respect to any contingent payment sale made after October 19, 1980 in a taxable year, ending after that date, for which the taxpayer has filed a federal income tax return prior to February 19, 1981. If in such tax return the taxpayer has treated the contingent payment sale under the installment method, consent of the Internal Revenue Service to a late election by the taxpayer not to report the transaction on the installment method will generally be granted if the request for election out of installment method treatment is filed by May 5, 1981. If in such tax return the taxpayer has elected not to report the contingent payment sale under the installment method, consent of the Service to revocation of the election by the taxpayer will generally be granted if the request for revocation is filed by May 5, 1981.

(e) *Purchaser evidences of indebtedness payable on demand or readily tradable*—(1) *Treatment as payment*—(i) *In general.* A bond or other evidence of indebtedness (hereinafter in this section referred to as an obligation) issued by any person and payable on demand shall be treated as a payment in the year received, not as installment obligations payable in future years. In addition, an obligation issued by a corporation or a government or political subdivision thereof—

(A) With interest coupons attached (whether or not the obligation is readily tradable in an established securities market),

(B) In registered form (other than an obligation issued in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(C) In any other form designed to render such obligation readily tradable in an established securities market,

shall be treated as a payment in the year received, not as an installment obligation payable in future years. For purposes of this paragraph, an obligation is to be considered in registered form if it is registered as to principal, interest, or both and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.

(ii) *Examples.* The rules stated in this paragraph may be illustrated by the following examples:

Example (1). On July 1, 1981, A, an individual on the cash method of accounting reporting on a calendar year basis, transferred all of his stock in corporation X (traded on an established securities market and having a fair market value of $1,000,000) to corporation Y in exchange for 250 of Y's registered bonds (which are traded in an over-the-counter-market) each with a principal amount and fair market value of $1,000 (with interest payable at the rate of 12 percent per year), and Y's unsecured promissory note with a principal amount of $750,000. At the time of such exchange A's basis in the X stock is $900,000. The promissory note is payable at the rate of $75,000 annually, due on July 1 of each year following 1981 until the

principal balance is paid. The note provides for the payment of interest at the rate of 12 percent per year also payable on July 1 of each year. Under the rule stated in paragraph (e)(1)(i) of this section, the 250 registered bonds of Y are treated as a payment in 1981 in the amount of the value of the bonds, $250,000.

Example (2). Assume the same facts as in example (1). Assume further that on July 1, 1982, Y makes its first installment payment to A under the terms of the unsecured promissory note with 75 more of its $1,000 registered bonds. A must include $7,500 (*i.e.*, 10 percent gross profit percentage times $75,000) A's gross income for calendar year 1982. In addition, A includes the interest payment made by Y on July 1 in A's gross income for 1982.

(2) *Amounts treated as payment.* If under paragraph (e)(1) of this section an obligation is treated as a payment in the year received, the amount realized by reason of such payment shall be determined in accordance with the taxpayer's method of accounting. If the taxpayer uses the cash receipts and disbursements method of accounting, the amount realized on such payment is the fair market value of the obligation. If the taxpayer uses the accrual method of accounting, the amount realized on receipt of an obligation payable on demand is the face amount of the obligation, and the amount realized on receipt of an obligation with coupons attached or a readily tradable obligation is the stated redemption price at maturity less any original issue discount (as defined in section 1232(b)(1)) or, if there is no original issue discount, the amount realized is the stated redemption price at maturity appropriately discounted to reflect total unstated interest (as defined in section 483(b)), if any.

(3) *Payable on demand.* An obligation shall be treated as payable on demand only if the obligation is treated as payable on demand under applicable state or local law.

(4) *Designed to be readily tradable in an established securities market*—(i) *In general.* Obligations issued by a corporation or government or political subdivision thereof will be deemed to be in a form designed to render such obligations readily tradable in an established securities market if—

(A) Steps necessary to create a market for them are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding which existed at the time of issuance),

(B) If they are treated as readily tradable in an established securities market under paragraph (e)(4)(ii) of this section, or

(C) If they are convertible obligations to which paragraph (e)(5) of this section applies.

(ii) *Readily tradable in an established securities market.* An obligation will be treated as readily tradable in an established securities market if—

(A) The obligation is part of an issue or series of issues which are readily tradable in an established securities market, or

(B) The corporation issuing the obligation has other obligations of a comparable character which are described in paragraph (e)(4)(ii)(A) of this section. For purposes of paragraph (e)(4)(ii)(B) of this section, the determination as to whether there exist obligations of a comparable character depends upon the particular facts and circumstances. Factors to be considered in making such determination include, but are not limited to, substantial similarity with respect to the presence and nature of security for the obligation, the number of obligations issued (or to be issued), the number of holders of such obligation, the principal amount of the obligation, and other relevant factors.

(iii) *Readily tradable.* For purposes of paragraph (e)(4)(ii)(A) of this section, an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market.

(iv) *Established securities market.* For purposes of this paragraph, the term ''established securities market'' includes (A) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (B) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1934 (15 U.S.C. 78e) because of the limited volume of transactions, and (c) any over-the-counter market. For purposes of this (iv), an

over-the-counter market is reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of business and containing only quotations of such broker or dealer.

(v) *Examples.* The rules stated in this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1982, 25 individuals owning equal interests in a tract of land with a fair market value of $1 million sell the land to corporation Y. The $1 million sales price is represented by 25 bonds issued by Y, each having a face value of $40,000. The bonds are not in registered form and do not have interest coupons attached, and, in addition, are payable in 120 equal installments, each due on the first business day of each month. In addition, the bonds are negotiable and may be assigned by the holder to any other person. However, the bonds are not quoted by any brokers or dealers who deal in corporate bonds, and, furthermore, there are no comparable obligations of Y (determined with reference to the characteristics set forth in paragraph (e)(2) of this section) which are so quoted. Therefore, the bonds are not treated as readily tradable in an established securities market. In addition, under the particular facts and circumstances stated, the bonds will not be considered to be in a form designed to render them readily tradable in an established securities market. The receipt of such bonds by the holder is not treated as a payment for purposes of section 453(f)(4), notwithstanding that they are freely assignable.

Example (2). On April 1, 1981, corporation M purchases in a casual sale of personal property a fleet of trucks from corporation N in exchange for M's negotiable notes, not in registered form and without coupons attached. The M notes are comparable to earlier notes issued by M, which notes are quoted in the Eastern Bond section of the National Daily Quotation Sheet, which is an interdealer quotation system. Both issues of notes are unsecured, held by more than 100 holders, have a maturity date of more than 5 years, and were issued for a comparable principal amount. On the basis of these similar characteristics it appears that the latest notes will also be readily tradable. Since an interdealer system reflects an over-the-counter market, the earlier notes are treated as readily tradable in an established securities market. Since the later notes are obligations comparable to the earlier ones, which are treated as readily tradable in an established securities market, the later notes are also treated as readily tradable in an established securities market (whether or not such notes are actually traded).

(5) *Special rule for convertible securities*—(i) *General rule.* If an obligation contains a right whereby the holder of such obligation may convert it directly or indirectly into another obligation which would be treated as a payment under paragraph (e)(1) of this section or may convert it directly or indirectly into stock which would be treated as readily tradable or designed to be readily tradable in an established securities market under paragraph (e)(4) of this section, the convertible obligation shall be considered to be in a form designed to render such obligation readily tradable in an established securities market unless such obligation is convertible only at a substantial discount. In determining whether the stock or obligation into which an obligation is convertible is readily tradable or designed to be readily tradable in an established securities market, the rules stated in paragraph (e)(4) of this section shall apply, and for purposes of such paragraph (e)(4) if such obligation is convertible into stock then the term ''stock'' shall be substituted for the term ''obligation'' wherever it appears in such paragraph (e)(4).

(ii) *Substantial discount rule.* Whether an obligation is convertible at a substantial discount depends upon the particular facts and circumstances. A substantial discount shall be considered to exist if at the time the convertible obligation is issued, the fair market value of the stock or obligation into which the obligation is convertible is less than 80 percent of the fair market value of the obligation (determined by taking into account all relevant factors, including proper discount to reflect the fact that the convertible obligation is not readily tradable in an established securities market and any additional consideration required to be paid by the taxpayer). Also, if a privilege to convert an obligation into stock or an obligation which is readily tradable in an established securities market may not be exercised within a period of one year from the date the

obligation is issued, a substantial discount shall be considered to exist.

(6) *Effective date.* The provisions of this paragraph (e) shall apply to sales or other dispositions occurring after May 27, 1969, which are not made pursuant to a binding written contract entered into on or before such date. No inference shall be drawn from this section as to any questions of law concerning the application of section 453 to sales or other dispositions occurring on or before May 27, 1969.

[T.D. 7768, 46 FR 10709, Feb. 4, 1981; 46 FR 13688, Feb. 24, 1981; 46 FR 43036, Aug. 26, 1981, as amended by T.D. 7788, 46 FR 48920, Oct. 5, 1981; T.D. 8535, 59 FR 18751, Apr. 20, 1994]

§ 15a.453–2 Installment obligations received as liquidating distribution. [Reserved]

PART 16—TEMPORARY REGULATIONS UNDER THE REVENUE ACT OF 1962

AUTHORITY: Sec. 7805, 68 Stat. 917; 26 U.S.C. 7805.

§ 16.3–1 Returns as to the creation of or transfers to certain foreign trusts.

(a) *Requirement of return.* Every United States person who, on or after October 16, 1962, either creates a foreign trust or transfers money or property to a foreign trust, directly or indirectly, shall file an information return on Form 3520, except as provided in subparagraph (4) of paragraph (d) of this section. The return must be filed by the grantor or the transferor, or the fiduciary of the estate in the case of a testamentary trust. The return must be filed whether or not any beneficiary is a United States person and whether or not the grantor or any other person may be treated as the substantial owner of any portion of the trust under sections 671–678.

(b) *Meaning of terms.* For purposes of this section the following terms shall have the meaning assigned to them in this paragraph:

(1) *Foreign trust.* See section 7701(a)(31) of the Code for the definition of foreign trust.

(2) *United States person.* See section 7701(a)(30) of the Code for the definition of United States person.

(3) *Grantor.* The term ''grantor'' refers to any United States person who by an inter vivos declaration or agreement creates a foreign trust.

(4) *Transferor.* The term ''transferor'' refers to any United States person, other than a person who is the grantor or the fiduciary (as defined in subparagraph (5) of this paragraph), who transfers money or property to or for the benefit of a foreign trust. It does not refer to a person who transfers money or property to a foreign trust pursuant to a sale or an exchange which is made for full and adequate consideration.

(5) *Fiduciary of an estate.* In the case of a testamentary trust expressed in the will of a decedent the term ''fiduciary of an estate'' refers to the executor or administrator who is responsible for establishing a foreign trust on behalf of the decedent.

(c) *Information required.* The return required by section 6048 and this section shall be made on Form 3520 and shall set forth the following information:

(1) The name, address, and identifying number of the person (or persons) filing the return, a statement identifying each person named as either a grantor, fiduciary of an estate, or transferor, and the date of the transaction for which the return is being filed;

(2) In the case of a fiduciary of an estate, the name and identifying number of the decedent;

(3) The name of the trust and the name of the country under whose laws the foreign trust was created;

(4) The date the foreign trust was created and the name and address of the person (or persons) who created it;

(5) The date on which the trust is to terminate or a statement describing the conditions which will cause the trust to terminate;

(6) The name and business address of the foreign trustee (or trustees);

(7) A statement either that the trustee is required to distribute all of the trust's income currently (in which case the information required in subparagraph (c)(9) of this paragraph need not be furnished) or a statement that the

trust may accumulate some or all of its income;

(8) The name, address, and identifying number, if any, of each beneficiary who is either named in the instrument or whose identity is definitely ascertainable at the time the return required by this section is filed, and the date of birth for each beneficiary who is a United States person and whose rights under the trust are determined, in whole or in part, by reference to the beneficiary's age;

(9) Except as provided in subparagraph (c)(7) of this paragraph, a statement with respect to each beneficiary setting forth his right to receive income or corpus, or both, from the trust, his proportionate interest, if any, in the income or corpus, or both, of the trust, and any condition governing the time when a distribution to him may be made, such as a specific date or age (or in lieu of such statement a copy of the trust instrument which must be attached to the return);

(10) A detailed list of the property transferred to the foreign trust in the transaction for which the return is being filed, containing a complete description of each item transferred, its adjusted basis and its fair market value on the date transferred, and the consideration, if any, paid by the foreign trust for such transfer; and

(11) The name and address of the person (or persons) having custody of the books of account and records of the foreign trust, and the location of such books and records if different from such address.

(d) *Special provisions*—(1) *Separate return for each foreign trust and each transfer.* If a United States person creates more than one foreign trust or transfers money or property to more than one foreign trust, then separate returns must be filed with respect to each foreign trust where returns are required under section 6048 and this section. If a United States person transfers money or property to the same foreign trust at different times, then separate returns must be filed with respect to each transfer where returns are required under section 6048 and this section. However, where more than one transfer to the same foreign trust is made by a United States person during any 90-day period, such person may, at his election, file a single return, so long as the return includes the information required with respect to each transfer and is filed on or before the 90th day after the earliest transfer in any such period.

(2) *Joint returns.* Where returns are required under section 6048 and this section by two or more persons who either jointly create a foreign trust or jointly transfer money or property to a foreign trust, they may jointly execute and file one return in lieu of filing several returns.

(3) *Actual ownership of money or property transferred.* If any person referred to in this section is not the real party in interest as to the money or property transferred but is merely acting for a United States person, the information required under this section shall be furnished in the name of and by the actual owner of such money or property, except that a fiduciary of an estate shall file information relating to the decedent.

(4) *Payments to an employees' trust, etc.* In the case of contributions made to a foreign trust under a plan which provides pension, profit-sharing, stock bonus, sickness, accident, unemployment, welfare, or similar benefits or a combination of such benefits for employees, neither employers nor employees shall be required to file a return as set forth in this section.

(e) *Time and place for filing return*—(1) *Time for filing.* Any return required by section 6048 and this section shall be filed on or before the 90th day after either the creation of any foreign trust by a United States person or the transfer of any money or property to a foreign trust by a United States person. The Director of International Operations is authorized to grant reasonable extensions of time to file returns under section 6048 and this section in accordance with the applicable provisions of section 6081(a) and § 1.6081–1.

(2) *Place for filing.* Returns required by section 6048 and this section shall be filed with the Director of International Operations, Internal Revenue Service, Washington D.C. 20225.

(f) *Penalties*—(1) *Criminal.* For criminal penalties for failure to file a return see section 7203. For criminal penalties

for filing a false or fraudulent return, see sections 7206 and 7207.

(2) *Civil.* For civil penalty for failure to file a return or failure to show the information required on a return under this section, see section 6677.

[T.D. 6632, 28 FR 277, Jan. 10, 1963]

PART 16A—TEMPORARY INCOME TAX REGULATIONS RELATING TO THE PARTIAL EXCLUSION FOR CERTAIN CONSERVATION COST-SHARING PAYMENTS

Sec.

16A.126–0 Effective dates.
16A.126–1 Certain cost-sharing payments—in general.
16A.126–2 Section 126 elections.
16A.1255–1 General rule for treatment of gain from disposition of section 126 property.
16A.1255–2 Special rules.

AUTHORITY: Secs. 126 and 7805 of the Internal Revenue Code of 1954 (92 Stat. 2888, 26 U.S.C. 126; 68A Stat. 917, 26 U.S.C. 7805).

SOURCE: T.D. 7778, 46 FR 27637, May 21, 1981, unless otherwise noted.

§ 16A.126–0 Effective dates.

These temporary regulations shall apply to any payments received under a contract signed by the taxpayer and the appropriate agency after September 30, 1979.

§ 16A.126–1 Certain cost-sharing payments—in general.

(a) *Introduction.* In general, section 126 provides that recipients of payments made after September 30, 1979 under certain conservation, reclamation and restoration programs may exclude all or a portion of those payments from income if the payments do not substantially increase the annual income derived by the taxpayer from the affected property. For purposes of this section, the term ''payment'' as used in section 126 means payment of the economic benefit, if any, conferred upon the taxpayer upon receipt of the improvement. An increase in annual income is substantial if it exceeds the greater of 10 percent of the average annual income derived from the affected property prior to receipt of the improvement or an amount equal to $2.50 times the number of affected acres. The amount of gross income which a taxpayer realizes upon the receipt of a section 126 payment is the value of the section 126 improvement, reduced by the sum of the excludable portion and the taxpayer's share of the cost of the improvement (if any).

(b) *Definitions.* For purposes of this section, the term:

(1) ''Cost of the improvement'' means the sum of amounts paid by a government and the taxpayer, whether or not with borrowed funds, for the improvement.

(2) ''Section 126 cost'' means the cost of the improvement less the sum of

(i) Any government payments under a program which is not listed in section 126(a),

(ii) Any portion of a government payment under a program which is listed in section 126(a) which the Secretary of Agriculture has not certified is primarily for purposes of conservation,

(iii) Any government payment to the taxpayer which is in the nature of rent or compensation for services.

(3) ''Value of the section 126 improvement'' means the fair market value of the improvement multiplied by a fraction, the numerator of which is the section 126 cost and the denominator of which is the cost of the improvement.

(4) ''Affected acreage'' means the acres affected by the improvement.

(5) ''Excludable portion'' means the present fair market value of the right to receive annual income from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or $2.50 times the number of affected acres.

(6) ''Prior average annual income'' means the average of the gross receipts from the affected acreage for the last three taxable years preceding the taxable year in which installation of the improvement is commenced.

(7) ''Section 126 improvement'' means the portion of the improvement equal to the percentage which government payments made to the taxpayer, which the Secretary of Agriculture has certified were made primarily for the purpose of conservation, bear to the cost of the improvement.

(c) *Income realized upon receipt of a section 126 improvement*—(1) *Section 126 exclusion applied.* Unless a taxpayer

elects not to have section 126 apply, the amount of gross income realized on receipt of the section 126 improvement is the value of the section 126 improvement less the sum of the taxpayer's share of the cost of the improvement and the excludable portion.

(2) *Section 126 exclusion not applied.* If a taxpayer elects under section 126(c) not to have section 126 apply in whole or in part, the amount realized on the receipt of the section 126 improvement is the value of the section 126 improvement less the sum of the taxpayer's share of the cost of the improvement and the excludable portion that applies, if any.

(d) *Payments under watershed programs*—(1) *Programs within section 126(a)(9).* Section 126(a)(9) covers certain programs affecting small watersheds.

These programs must be administered by the Secretary of Agriculture and be determined by the Commissioner to be substantially similar to the type of program described in section 126(a) (1) through (8). The Commissioner has determined that section 126 improvements made in connection with small watersheds are within the scope of section 126(a)(9) if they are made under one of the following programs:

(A) The Watershed Protection and Flood Prevention Act, Pub. L. 566, 68 Stat. 666, as amended (16 U.S.C. 1001, *et seq.*), as funded by the Act of November 9, 1979, Pub. L. 96–108, 93 Stat. 834.

(B) Flood Prevention Projects, Pub. L. 86–468, sec. 1, 74 Stat. 131, as amended (16 U.S.C. 1006a); Pub. L. 78–534, sec. 2, 58 Stat. 889 (33 U.S.C. 701a–1); Pub. L. 78–534, sec. 13, 58 Stat. 905;

(C) Emergency Watershed Protection, Pub. L. 81–516, sec. 216, 64 Stat. 184 (33 U.S.C. 701b–1), and

(D) Colorado River Basin Salinity Control Act, Pub. L. 93–320, 88 Stat. 266:

(1) Title 1—Programs downstream from Imperial Dam, and

(2) Title 2—Measures upstream from Imperial Dam.

(2) *Other programs.* The Commissioner may announce further determinations under section 126(a)(9) from time to time in the Internal Revenue Bulletin.

(3) *Small watershed defined.* A watershed is a ''small watershed'' under this paragraph and section 126(a)(9) if the watershed or subwatershed does not exceed 250,000 acres and does not include any single structure providing more than 12,500 acre-feet of floodwater detention capacity, nor more than 25,000 acre-feet of total capacity.

(e) *Basis of property not increased by reason of excludable amounts.* Notwithstanding any provision of section 1016 (relating to adjustments to basis) to the contrary, basis of any property does not include any amount which is excludable from gross income under section 126.

(f) *Cross reference.* For rules relating to the recapture as ordinary income of the gain from the disposition (within 20 years of the date of receipt) of property for which an exclusion is claimed for a section 126 improvement, see section 1255 and the regulations thereunder.

(g) *Examples.* The provisions of this section are illustrated by the following examples:

Example (1). In 1981, 100 acres of the taxpayer's land is reclaimed under a Rural Abandoned Mine Program contract with the Soil Conservation Service of the U.S. Department of Agriculture. The total cost of the improvement is $700,000. USDA pays $690,000, the taxpayer $10,000. The Secretary of Agriculture certifies that 95% of the $690,000 USDA payment was primarily for the purpose of conservation. Therefore, $34,500 ($690,000×.05) is a nonsection 126 payment. $150,000 of USDA's payment is compensation for the taxpayer's service in the reclamation project and is includable in gross income as compensation for services. The taxpayer has $20,000 of allowable deductions in 1981, $15,500 of which are properly attributable to the USDA payment. Based on all the facts and circumstances, the value of the improvement is $21,000. The taxpayer elects not to have section 126 apply. The taxpayer computes the amount which is included in gross income as a result of receipt of the improvement as follows:

(1)

Cost of improvement	$700,000
Nonsection 126 payment	(34,500)
Compensation for services	(150,000)
Current deductions	(15,500)
Section 126 cost	500,000

(2)

Value of improvement	21,000
Multiplied by section 126 cost	×500,000
Cost of improvement	700,000

Value of section 126 improvement	15,000

(3)

Value of section 126 improvement	15,000
(Taxpayer's contribution)	10,000
Amount included in gross income	5,000

Example (2). The facts are the same as example (1) except that section 126 applies. Based on all the facts and circumstances, the present fair market value of the right to receive annual income from the property of 10 percent of the prior average annual income of the affected acreage prior to the receipt of the improvement is $1,380 and the present fair market value of the right to receive $250 ($2.50×100 acres) is $1,550. The excludable portion is, therefore, $1,550. The taxpayer computes the amount included in gross income as follows:

Value of section 126 improvement	$15,000
(Taxpayer's contribution)	(10,000)
(Excludable portion)	(1,550)
Amount included in income	3,450

Example (3). The facts are the same as example (2) except that the present value of 10 percent of the prior average annual income is $5,600. The taxpayer realizes no income as a result of receipt of the section 126 project.

(1)

Value of section 126 improvement	$15,000
(Taxpayer's contribution)	(10,000)
(Excludable portion)	(5,600)
Amount included in income	0

Example (4). In 1983, the taxpayer signs a contract under the water bank program under which he will maintain 20 acres of undisturbed wetlands as a wildfowl preserve. In return he will receive $90 an acre as rent from the government. Although the payment is made under a program listed in section 126(a) and the Secretary of Agriculture has certified that the entire amount of payment was made primarily for the purpose of conservation, there is no income eligible for section 126 exclusion because the full payment is rent. The rent is included in full in gross income.

Example (5). In 1980, the taxpayer reforests 200 acres of nonindustrial private forest land by planting tree seedlings. The taxpayer pays the full cost of the reforestation, $15,000. Under the cost-sharing provisions of the forestry incentives program, the taxpayer receives a reimbursement from USDA of $12,000. The Secretary of Agriculture certifies that 100% of the USDA payment is primarily for the purpose of conservation. Assume that the excludable portion is $3,500 and that based on all the facts and circumstances, the value of the improvement is $15,000. The amount which is includable in income is the value of the section 126 improvement, reduced by the excludable portion and the taxpayer's share of the cost of the improvement. Therefore the taxpayer includes $8,500 in gross income as a result of the USDA payment, computed as follows:

Value of the section 126 improvement	$15,000
(Excludable portion)	(3,500)
(Taxpayer's contribution)	(3,000)
Amount included in gross income	8,500

[T.D. 7748, 46 FR 27637, May 21, 1981; 46 FR 41043, Aug. 14, 1981]

§ 16A.126–2 Section 126 elections.

(a) *Election for section 126 not to apply in whole or in part.* A taxpayer may elect under section 126(c) not to have section 126 apply to all or any part of an improvement described in section 126.

(b) *Application of the section 126 exclusion.* To the extent the section 126 exclusion applies, the taxpayer should so indicate on an attachment to the tax return (or amended return) for the taxable year in which the taxpayer received the last payment made by a government for the improvement. The attachment should state the dollar amount of the section 126 cost funded by a government payment, the value of the section 126 improvement, and the amount that the taxpayer is excluding under section 126.

§ 16A.1255–1 General rule for treatment of gain from disposition of section 126 property.

(a) *Ordinary income*—(1) *General rule.* Except as otherwise provided in this section and § 16A.1255–2, if section 126 property is disposed of after September 30, 1979, then under section 1255(a)(1) there shall be recognized as ordinary income the lesser of—

(i) The ''excludable portion'' under section 126, or

(ii)(A) The excess of the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of the section 126 property (in the case of any other disposition), over the adjusted basis of the property, less

(B) The amount recognized as ordinary income under the other provisions of Chapter I, Subchapter P, Part IV of the Code.

(2) *Application of section.* Any gain treated as ordinary income under section 1255(a)(1) shall be recognized as ordinary income notwithstanding any other provision of subtitle A of the Code except that section 1255 does not apply to the extent the gain is recognized as ordinary income under the other provisions of Subchapter P, Part IV of the Code. For special rules with respect to the application of section 1255, see § 16A.1255–2. For the relation of section 1255 to other provisions, see paragraph (c) of this section.

(3) *Meaning of terms.* For purposes of section 1255 and these regulations—

(i) The term ''section 126 property'' means any property acquired, improved, or otherwise modified as a result of a payment listed in section 126(a) which has been certified by the Secretary of Agriculture as primarily for the purpose of conservation;

(ii) The term ''excludable portion'' is defined in § 16A.126–1(b)(5);

(iii) The term ''disposition'' has the same meaning as in § 1.1245–1(a)(3);

(iv) The term ''date of receipt of the section 126 payment'' means the last date the government made a payment for the improvements.

(4) *Applicable percentage.* If section 126 property is disposed of less than 10 years after the date of receipt of the last payment which has been certified by the Secretary of Agriculture as primarily for the purpose of conservation, the ''applicable percentage'' is 100 percent; if section 126 property is disposed of more than 10 years after that date, the applicable percentage is 100 percent reduced (but not below zero) by 10 percent for each year or part thereof in excess of 10 years such property was held after the date of the section 126 payment.

(5) *Portion of parcel.* The amount of gain to be recognized as ordinary income under section 1255(a)(1) shall be determined separately for each parcel of section 126 property in a manner consistent with the principles of § 1245–1(a) (4) and (5) relating to gain from disposition of certain depreciable property. If (i) only a portion of a parcel of section 126 property is disposed of in a transaction, or if two or more portions of a single parcel are disposed of in one transaction, and (ii) the aggregate of ''excludable portions'' with respect to any such portion cannot be established to the satisfaction of the Commissioner, then the aggregate of the ''excludable portions'' in respect of the entire parcel shall be allocated to each portion in proportion to the fair market value of each at the time of the disposition.

(b) *Instances of nonapplication*—(1) *In general.* Section 1255 does not apply if a taxpayer disposes of section 126 property more than 20 years after receipt of the last section 126 payment with respect to the property.

(2) *Losses.* Section 1255(a)(1) does not apply to losses. Thus, section 1255(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is section 126 property, nor does the section apply to a disposition of the property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of the property is not greater than its adjusted basis.

(c) *Relation of section 1255 to other provisions*—(1) *General.* The provisions of section 1255 apply notwithstanding any other provisions of Subtitle A of the Code except that they do not apply to the extent gain is recognized as ordinary income under the other provisions of Subchapter P, Part IV of the Code. Thus, unless an exception or limitation under § 16A.1255–2 applies, gain under section 1255(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision. For example, since section 1255 overrides section 1231 (relating to property used in the trade or business), the gain recognized under section 1255 upon a disposition of section 126 property will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of property to which section 1231 applies. See example (1) of paragraph (d) of this section.

(2) *Nonrecognition sections overridden.* The nonrecognition of gain provisions of Subtitle A of the Code which section 1255 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337,

and 512(b)(5). See § 16A.1255–2 for the extent to which section 1255(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, and 1033.

(3) *Installment method.* Gain from a disposition to which section 1255(a)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such a case, the portion of the installment payment that is gain is treated as follows: first as ordinary gain under other sections of Chapter I Subchapter P, Part IV of the Code until all that gain has been reported; next as ordinary gain to which section 1255 applies until all that gain is reported; and finally as gain under other sections of Chapter I, Subchapter D, Part IV of the Code. For treatment of amounts as interest on certain deferred payments, see section 483.

(4) *Exempt income.* With regard to exempt income, the principles of § 1.1245–6(e) shall be applicable.

(5) *Treatment of gain not recognized under section 1255(a)(1).* For treatment of gain not recognized under this section, the principles of § 1.1245–6(f) shall be applicable.

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

Example (1). Individual A uses the calendar year as his taxable year. On April 10, 1995, A sells for $75,000 section 126 property with an adjusted basis of $52,500 for a realized gain of $22,500. The excludable portion under section 126 was $18,000. A received the section 126 payment on January 5, 1990. No gain is recognized as ordinary gain under sections 1231 through 1254. Because the applicable percentage, 100 percent, of the aggregate of the section 126 improvements ($18,000), $18,000, is lower than the gain realized, $22,500, the amount of gain recognized as ordinary income under section 1255(a)(1) is $18,000. The remaining $4,500 of the gain may be treated as gain from the sale or exchange of property described in section 1231.

§ 16A.1255–2 Special rules.

(a) *Exception for gifts*—(1) *General rule.* In general, no gain shall be recognized under section 1255(a)(1) upon a disposition of section 126 property by gift. For purposes of section 1255 and this paragraph, the term ''gift'' shall have the same meaning as in § 1.1245–4(a) and, with respect to the application of this paragraph, principles illustrated by the examples of § 1.1245–4(a)(2) shall apply.

(2) *Disposition in part a sale or exchange and in part a gift.* Where a disposition of section 126 property is in part a sale or exchange and in part a gift, the amount of gain which shall be recognized as ordinary income under section 1255(a)(1) shall be computed under § 16A.1255–1(a)(1), applied by treating the gain realized (for purposes of § 16A.1255–1(a)(1)(ii)), as the excess of the amount realized over the adjusted basis of the section 126 property.

(3) *Treatment of section 126 property in hands of transferee.* See paragraph (d) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

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

Example (1). On March 2, 1986, A makes a gift to B of a parcel of land having an adjusted basis of $40,000 and fair market value of $65,000. On the date of that gift, the aggregate of excludable portions under section 126 was $24,000. The section 126 payments were all received on January 15, 1981. Upon making the gift, A recognizes no gain under section 1255(a)(1). See paragraph (a)(1) of this section. For treatment of the property in the hands of B, see example (1) of paragraph (d)(3) of this section.

Example (2). (i) Assume the same facts as in example (1), except that A transfers the land to B for $50,000. Assume further that no gain is recognized as ordinary income under any other provision of Chapter I, Subchapter P, Part IV of the Code. Thus, the gain realized is $10,000 (amount realized, $50,000, minus adjusted basis, $40,000), and A has made a gift of $15,000 (fair market value, $65,000, minus amount realized, $50,000).

(ii) Upon the transfer of the land to B, A recognizes $10,000 as ordinary income under section 1255(a)(1), computed under paragraph (a)(2) of this section as follows:

(1) Aggregate of excludable portions under section 126	$24,000
(2) Multiply: Applicable percentage for land disposed if within sixth year after section 126 payments were received	100
(3) Amount in § 16A.1255–1(a)(1)(i)	$24,000
(4) Gain realized (see (i) of this example)	10,000
(5) Amount in § 16A.1255–1(a)(1)(ii) applied in accordance with paragraph (a)(2) of this section	10,000
(6) Lower of line (3) or line (5)	10,000

Thus, the entire gain realized on the transfer, $10,000, is recognized as ordinary income.

For treatment of the farm land in the hands of B, see example (2) of paragraph (d)(3) of this section.

(b) *Exception for transfer at death*—(1) *In general.* Except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1255(a)(1) upon a transfer at death. For purposes of section 1255 and this paragraph, the term ''transfer at death'' shall have the same meaning as in § 1.1245–4(b) and, with respect to the application of this paragraph, principles illustrated by the examples of § 1.1245–4(b)(2) shall apply.

(2) *Treatment of section 126 property in hands of transferee.* If, as of the date a person acquires section 126 property from a decedent, the person's basis is determined by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death, or on the applicable date provided in section 2032 (relating to alternative valuation date), then on that date the aggregate of excludable portions under section 126 in the hands of such transferee is zero.

(c) *Limitation for certain tax-free transactions*—(1) *Limitation on amount of gain.* Upon a transfer of section 126 property described in paragraph (c)(2) of this section, the amount of gain recognized as ordinary income under section 1255(a)(1) shall not exceed an amount equal to the excess (if any) of (i) the amount of gain recognized to the transferor on the transfer (determined without regard to section 1255) over (ii) the amount (if any) of gain recognized as ordinary income under the other provisions of Chapter I, Subchapter P, Part IV of the Code. For purposes of paragraph (c)(1) of this section, the principles of § 1.1245–4(c)(1) shall apply. Thus, in the case of a transfer of section 126 property and other property in one transaction, the amount realized from the disposition of the section 126 property (as determined in a manner consistent with the principles of § 1.1245–1(a)(5)) shall consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of the acquired property as the amount realized from the disposition of the section 126 property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 1255) which is eligible to be recognized as ordinary income under section 1255(a)(1). The provisions of this paragraph do not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by Chapter I of the Code.

(2) *Transfers covered.* The transfers referred to in paragraph (c)(1) of this section are transfers of section 126 property in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). For application of paragraph (c)(1) of this section to such a complete liquidation, the principles of § 1.1245–4(c)(3) shall apply. Thus, for example, the provisions of paragraph (c)(1) of this section do not apply to a liquidating distribution of section 126 property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(ii) Section 351 (relating to transfer to a corporation controlled by the transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest). See paragraph (e) of this section.

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover of basis rule, see paragraph (e) of this section.

(viii) Section 1031 (relating to like kind exchanges).

(ix) Section 1034 (relating to rollover of gain on the sale of a principal residence).

(3) *Treatment of section 126 property in the hands of transferee.* See paragraph (d) of this section for treatment of the transferee in the case of a disposition to which this paragraph applies.

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

Example (1). On January 4, 1986, A holds a parcel of property that is section 126 property having an adjusted basis of $15,000 and a fair market value of $40,000. On that date he transfers the parcel to corporation M in exchange for stock in the corporation worth $40,000 in a transaction qualifying under section 351. On the date of the transfer, the aggregate of excludable portions under section 126 with respect to the transferred property is $18,000 and all of such amount was received on March 25, 1981. With regard to section 1255, A would recognize no gain under section 351 upon the transfer and M's basis for the land would be determined under section 362(a) by reference to its basis in the hands of A. Thus, as a result of the disposition, no gain is recognized as ordinary income under section 1255 by A since the amount of gain recognized under that section is limited to the amount of gain which is recognized under section 351 (determined without regard to section 1255). See paragraph (c)(1) of this section. For treatment of the section 126 property in the hands of B, see paragraph (d)(1) of this section.

Example (2). Assume the same facts in example (1), except that A transferred the property to M for stock in the corporation worth $32,000 and $8,000 cash. The gain realized is $25,000 (amount realized, $40,000, minus adjusted basis, $15,000). Without regard to section 1255, A would recognize $8,000 of gain under section 351(b). Assume further that no gain is recognized as ordinary income under the other provisions of Chapter I, Subchapter P, Part IV of the Code. Therefore, since the applicable percentage, 100 percent of the aggregate excludable portions under section 126, $18,000, is lower than the gain realized, $25,000, the amount of gain to be recognized as ordinary income under section 1255(a)(1) would be $18,000 if the provisions of paragraph (c)(1) of this section do not apply. Since under section 351(b) gain in the amount of $8,000 would be recognized to the transferor without regard to section 1255, the limitation provided in paragraph (c)(1) of this section limits the gain taken into account by A under section 1255(a)(1) to $8,000.

Example (3). Assume the same facts as in example (2), except that $5,000 of gain is recognized as ordinary income under section 1251(c)(1). The amount of gain recognized as ordinary income under section 1255(a)(1) is $3,000 computed as follows:

(1) Amount of gain under section 1255(a)(1) (determined without regard to paragraph (c)(1) of this section):	
(a) Aggregate of excludable portions under section 126	$18,000
(b) Multiply: Applicable percentage for property disposed of within the fifth year after section 126 payments were received (percent)	100
(c) Amount in § 16A.1255–1(a)(1)(i)	$18,000
(d) Gain realized (amount realized $40,000 less adjusted basis, $15,000)	$25,000
(e) Lower of line (c) or line (d)	$18,000
(2) Limitation in paragraph (c)(1) of this section:	
(a) Gain recognized (determined without regard to section 1255)	$8,000
(b) Minus: Gain recognized as ordinary income under section 1251(c)(1)	$5,000
(c) Difference	$3,000
(3) Lower of line (1)(e) or line (2)(c)	$3,000

Thus, the entire gain recognized under section 351(b) (determined without regard to sections 1251 and 1255), $8,000, is recognized as ordinary income since that amount is equal to the sum of the gain recognized as ordinary income under section 1251(c)(1), $5,000, and under section 1255(a)(1), $3,000.

(d) *Treatment of section 126 property received by a transferee in a disposition by gift and certain tax-free transactions*—(1) *General rule.* If section 126 property is disposed of in a transaction which is either a gift to which paragraph (a)(1) of this section applies, or a completely tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1255—

(i) The aggregate of the excludable portions under section 126 in respect of the land in the hands of the transferee immediately after the disposition shall be an amount equal to the amount of such aggregate in the hands of the transferor immediately before the disposition, and

(ii) For purposes of applying section 1255 upon a subsequent disposition by the transferee (including a computation of the applicable percentage), the dates of receipt of section 126 payments shall not be affected by the dispositions.

(2) *Certain partially tax-free transfers.* If section 126 property is disposed of in a transaction which either is in part a sale or exchange and in part a gift to which paragraph (a)(2) of this section

applies, or is a partially tax-free transfer to which paragraph (c)(1) of this section applies, then for purposes of section 1255 the amount determined under paragraph (d)(1) of this section shall be reduced by the amount of gain taken into account under section 1255 by the transferor upon the disposition. Upon a subsequent disposition by the transferee, the dates of receipt of section 126 payments remain the same in the hands of the transferee as they were in the hands of the transferor. With respect to the 175 and 182 deductions taken by the transferee, the holding period shall not include the holding period of the transferor.

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

Example (1). Assume the same facts as in example (1) of paragraph (a)(4) of this section. Therefore, on the date B receives the land in the gift transaction, under paragraph (d)(1) of this section the aggregate of excludable portions under section 126 in respect of the land in the hands of B is the amount in the hands of A, $24,000, and for purposes of applying section 1255 upon a subsequent disposition by B (including a computation of the applicable percentage) the date the section 126 payments were received is the same as it was when the property was in A's hands (January 15, 1981).

Example (2). Assume the same facts as in example (2) of paragraph (a)(4) of this section. Under paragraph (d)(2) of this section, the aggregate of excludable portions under section 126 which pass over to B for purposes of section 1255 is $14,000 ($24,000 excluded under section 126 minus $10,000 gain recognized under section 1255(d)(1) in accordance with example (2) of paragraph (a)(4) of this section). The date the section 126 payments were received is the same as when the property was in B's hands (January 15, 1981).

(e) *Disposition of section 126 property not specifically covered.* If section 126 property is disposed of in a transaction not specifically covered under § 16A.1255–1, and this section, then the principles of section 1245 shall apply.

PART 17—TEMPORARY INCOME TAX REGULATIONS UNDER 26 U.S.C. 103(c)

AUTHORITY: Sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917 (26 U.S.C. 7805).

§ 17.1 Industrial development bonds used to provide solid waste disposal facilities; temporary rules.

(a) *In general.* Section 103(c)(4)(E) provides that section 103(c)(1) shall not apply to obligations issued by a State or local governmental unit which are part of an issue substantially all the proceeds of which are used to provide solid waste disposal facilities. Section 1.103–8(f) of this chapter provides general rules with respect to such facilities and defines such facilities. In the case of property which has both a solid waste disposal function and a function other than the disposal of solid waste, only the portion of the cost of the property allocable to the function of solid waste disposal (as determined under paragraph (b) of this section) is taken into account as an expenditure to provide solid waste disposal facilities. A facility which otherwise qualifies as a solid waste disposal facility will not be treated as having a function other than solid waste disposal merely because material or heat which has utility or value is recovered or results from the disposal process. Where materials or heat are recovered, the waste disposal function includes the processing of such materials or heat which occurs in order to put them into the form in which the materials or heat are in fact sold or used, but does not include further processing which converts the materials or heat into other products.

(b) *Allocation.* The portion of the cost of property allocable to solid waste disposal is determined by allocating the cost of such property between the property's solid waste disposal function and any other functions by any method which, with reference to all the facts and circumstances with respect to such property, reasonably reflects a separation of costs for each function of the property.

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

Example. Company A intends to construct a new facility to process solid waste which City X will deliver to the facility. City X will pay a disposal fee for each ton of solid waste that City X dumps at the facility. The waste will be processed by A in a manner which separates metals, glass, and similar materials. As separated, some of such items are

commercially saleable; but A does not intend to sell the metals and glass until the metals are further separated, sorted, sized, and cleaned and the glass is pulverized. The metals and pulverized glass will then be sold to commercial users. The waste disposal function includes such processing of the metals and glass, but no further processing is included.

The remaining waste will be burned in an incinerator. Gases generated by the incinerator will be cleaned by use of an electrostatic precipitator. To reduce the size and cost of the electrostatic precipitator, the incinerator exhaust gases will be cooled and reduced in volume by means of a heat exchange process using boilers. The precipitator is functionally related and subordinate to disposal of the waste residue and is therefore property used in solid waste disposal. The heat can be used by A to produce steam. Company B operates an adjacent electric generating facility and B can use steam to power its turbine-generator. B needs steam with certain physical characteristics and as a result A's boilers, heat exchanger and related equipment are somewhat more costly than might be required to produce steam for some other uses. The disposal function includes the equipment actually used to put the heat into the form in which it is sold.

Company A intends to construct pipes to carry the steam from A's boiler to B's facility. When converted to such steam the heat is in the form in which sold, and therefore the disposal function does not include subsequent transporting of the steam by pipes. Similarly, if A installed generating equipment and used the steam to generate electricity, the disposal function would not include the generating equipment, since such equipment transforms the commercially saleable steam into another form of energy.

[T.D. 7362, 40 FR 26028, June 20, 1975]

PART 18—TEMPORARY INCOME TAX REGULATIONS UNDER THE SUBCHAPTER S REVISION ACT OF 1982

Sec.

18.0 Effective date of temporary regulations under the Subchapter S Revision Act of 1982.
18.1371–1 Election to treat distributions as dividends during certain post-termination transition periods.
18.1378–1 Taxable year of S corporation.
18.1379–1 Transitional rules on enactment.
18.1379–2 Special rules for all elections, consents, and refusals.

AUTHORITY: 26 U.S.C. 7805.

SOURCE: T.D. 7872, 48 FR 3590, Jan. 26, 1983, unless otherwise noted.

§ 18.0 Effective date of temporary regulations under the Subchapter S Revision Act of 1982.

The temporary regulations provided under § 18.1377–1, 18.1379–1, and 18.1379–2 are effective with respect to taxable years beginning after 1982, and the temporary regulations provided under § 18.1378–1 are effective with respect to elections made after October 19, 1982.

[T.D. 8600, 60 FR 37588, July 21, 1995]

§ 18.1371–1 Election to treat distributions as dividends during certain post-termination transition periods.

A corporation may make an election under section 1371(e) (as amended by section 721(o) of the Act) to treat all distributions of money made during the post-termination transition period described in section 1377(b)(1)(A) as coming out of the corporation's earnings and profits (after earnings and profits have been eliminated, the distributions are applied against and reduce the adjusted basis of the stock). The election may be made only with the consent of each shareholder to whom the corporation makes a distribution (whether or not it is a cash distribution) during such post-termination transition period. Any such election shall be made by the corporation by attaching to its income tax return for the C year in which such post-termination transition period ends a statement which clearly indicates that the corporation elects to have section 1371(e)(1) not apply to all distributions made during such post-termination transition period. The election shall not be effective unless such statement is signed by a person authorized to sign the return required to be filed under section 6012 and by each shareholder required to consent to the election.

[T.D. 7976, 49 FR 35493, Sept. 10, 1984]

§ 18.1378–1 Taxable year of S corporation.

(a) *In general.* No corporation may make an election be an S corporation for any taxable year unless the taxable year is a permitted year. In addition, an S corporation shall not change its taxable year to any taxable year other than a permitted year. A permitted

year is a taxable year ending on December 31 or is any other taxable year for which the corporation establishes a business purpose (within the meaning of § 1.442–1(b)(1)) to the satisfaction of the Commissioner.

(b) *Corporations qualifying for automatic change of taxable year to a taxable year ending December 31 and corporations adopting a taxable year ending December 31*—(1) *Qualification for automatic change.* Notwithstanding section 442 (relating to change of taxable year) and the regulations thereunder, a corporation may automatically change its taxable year to a taxable year ending on December 31 to comply with the permitted year requirement if all of its principal shareholders have taxable years ending on December 31, or if all of its principal shareholders concurrently change to such taxable year. A shareholder may not change his or her taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder. For purposes of this paragraph, a principal shareholder is a shareholder having 5% or more of the issued and outstanding stock of the corporation. See paragraph (d) of this section in the case where a corporation does not qualify under this subparagraph for an automatic change of its taxable year to a taxable year ending on December 31.

(2) *Effect of filing an election*—(i) *General rule.* The filing of an election to be an S corporation by a corporation that has, prior to making the election, adopted a taxable year ending other than on December 31, and that qualifies under paragraph (b)(1) of this section for an automatic change of its taxable year to a taxable year ending on December 31, shall constitute such automatic change for the first taxable year for which the election is effective. The filing of an election to be an S corporation by a corporation that has not, prior to making the election, adopted a taxable year shall constitute the adoption of a taxable year (or, if the corporation qualifies under paragraph (b)(1) of this section for the automatic change, the change to a taxable year) ending on December 31 for the first taxable year for which the election is effective. Where the taxable year has been changed pursuant to this subdivision and paragraph (b)(1) of this section, the first taxable year for which the election shall be effective shall commence on the first day of the first taxable year for which the election would have been effective if the taxable year had not been changed and shall end on December 31 of that taxable year. See § 1.1362–6(b)(2)(ii) of this chapter for the time within which to make an election to be an S corporation.

(ii) *Request to retain (or adopt) a taxable year ending other than December 31.* A request to retain (or adopt) a taxable year ending other than on December 31 by a corporation subject to paragraph (b)(2)(i) of this section shall (except as provided in paragraph (b)(3)(ii) of this paragraph and in paragraph (c) of this section) be made on Form 2553 when the election to be an S corporation is filed. See § 1.1362–6(b)(2)(i) of this chapter for the manner of making an election to be an S corporation. If such corporation receives permission to retain (or adopt) a taxable year ending other than on December 31, the election shall be effective and the provisions of paragraph (b)(2)(i) of this section shall be inapplicable. Denial of the request shall render the election ineffective unless—

(A) The request is accompanied by another request in which the corporation states that, in the event the request to retain (or adopt) a taxable year ending other than on December 31 is denied, it chooses to be governed by the provisions of paragraph (b)(2)(i) of this section, or

(B) The Commissioner waives the requirement to file the additional request described in paragraph (b)(2)(ii)(A) of this section and permits the corporation to be governed by the provisions of paragraph (b)(2)(i) of this section.

(c) [Reserved]

(d) *Elections by corporations not qualifying for automatic change.* An election to be an S corporation made after October 19, 1982, by a corporation that has a taxable year ending other than on December 31, and that does not qualify under paragraph (b)(1) of this section for an automatic change of its taxable year to a taxable year ending on December 31, shall be ineffective unless

the corporation has first secured a permitted year. At the request of a corporation wishing to secure a permitted year, the Commissioner shall make a determination that—

(1) The corporation's taxable year is a permitted year, or

(2) The corporation may, under § 1.442–1(b)(1), change its taxable year to a taxable year ending on December 31, or

(3) The corporation may, under §1.442–1(b)(1), change its taxable year to a taxable year ending other than on December 31, which taxable year shall be a permitted year.

[T.D. 7872, 48 FR 3590, Jan. 26, 1983; 48 FR 33481, July 22, 1983, as amended by T.D. 8123, 52 FR 3623, Feb. 5, 1987; T.D. 8600, 60 FR 37589, July 21, 1995]

§ 18.1379–2 Transitional rules on enactment.

(a) *Prior elections.* Any election that was made under section 1372(a) (as in effect before the enactment of the Subchapter S Revision Act of 1982), and that is still in effect as of the first day of a taxable year beginning in 1983, shall be treated as being an election made under section 1362(a). In addition, any election that was made under section 1371(g)(2) (as in effect before the enactment of that Act), and that is still in effect as of the first day of a taxable year beginning in 1983, shall be treated as being an election made under section 1362(d)(2).

(b) *Prior terminations.* For purposes of section 1362(g), any termination under section 1372(e) (as in effect before the enactment of the Subchapter S Revision Act of 1982) shall not be taken into account.

(c) *Time and manner of making an election under section 6(c)(3)(B) of the Subchapter S Revision Act of 1982.* In the case of a qualified oil corporation (as defined in section 6(c)(3)(B) of the Subchapter S Revision Act of 1982), the corporation may elect under that section of the Act to have the amendments made by the Act not apply and to have Subchapter S (as in effect on July 1, 1982), Chapter I of the Internal Revenue Code of 1954 apply. The election shall be made by the corporation by filing a statement that—

(1) Contains the name, address, and taxpayer identification number of the corporation and of each shareholder,

(2) Identifies the election as an election under section 6(c)(3)(B) of the Subchapter S Revision Act of 1982, and

(3) Provides all information necessary in the judgment of the district director to show that the corporation meets the requirements (other than the requirement of making this election) of a qualified oil corporation.

The statement shall be signed by any person authorized to sign the return required to be filed under section 6037 and by each person who is or was a shareholder in the corporation at any time during the taxable year beginning in 1983 and shall be filed with the return for that taxable year.

§ 18.1379–2 Special rules for all elections, consents, and refusals.

(a) *Additional information required.* If later regulations issued under the section of the Code or of the Subchapter S Revision Act of 1982 under which the election, consent, or refusal was made require the furnishing of information in addition to that which was furnished with the statement of election, consent, or refusal as provided by part 18 of this title, and if an office of the Internal Revenue Service requests the taxpayer to provide the additional information, the taxpayer shall furnish the additional information in a statement filed with that office of the Internal Revenue Service within 60 days after the date on which the request is made. This statement shall also—

(1) Contain the name, address, and taxpayer identification number of each party identified in connection with the election, consent, or refusal,

(2) Identify the election, consent, or refusal by reference to the section of the Code or Act under which the election, consent, or refusal was made, and

(3) Specify the scope of the election, consent, or refusal.

If the additional information is not provided within 60 days after the date on which the request is made, the election, consent, or refusal may, at the discretion of the Commissioner, be held invalid.

(b) *State law incorporator.* For purposes of any election, consent, or refusal provided in part 18 of this title, any person who is considered to be a shareholder for state law purposes solely by virtue of his or her status as an incorporator shall not be treated as a shareholder.

PART 19—TEMPORARY REGULATIONS UNDER THE REVENUE ACT OF 1964

AUTHORITY: 26 U.S.C. 7805.

§ 19.3–1 Interest on certain deferred payments; interest rate for use in determining whether there is total unstated interest under a contract.

(a) *In general.* Section 224(a) of the Revenue Act of 1964 adds a new section 483 to the Internal Revenue Code of 1954. Section 483(a) provides, generally, that in the case of any contract for the sale or exchange of property (which is a capital asset or section 1231 property) there shall be treated as interest that part of a payment to which section 483 applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which such section applies which are due under the contract. Section 483(b) defines the term ''total unstated interest'', with respect to a contract for the sale or exchange of property, as an amount equal to the excess of—

(1) The sum of the payments to which section 483 applies which are due under the contract, over

(2) The sum of the present values of such payments and the present values of any interest payments due under the contract.

Section 483(b) further provides that, for purposes of section 483(b)(2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary or his delegate, and that such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment. Section 483(c) provides that, except as provided in section 483(f) (relating to exceptions and limitations), section 483 shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract under which some or all of the payments are due more than one year after the date of such sale or exchange, and under which, using a rate provided by regulations (for purposes of section 483(c)(1)(B)), there is total unstated interest. Section 483(c) further provides that any rate prescribed for determining whether there is total unstated interest for purposes of section 483(c)(1)(B) shall be at least one percentage point lower than the rate prescribed for purposes of section 483(b)(2).

(b) *Rate of interest and table of present values for purposes of section 483(c)(1)(B).* For purposes of determining under section 483(c)(1)(B) whether there is total unstated interest under a contract (other than a contract of sale or exchange under which the purchaser is the United States, a State, or any other purchaser described in section 103) which provides for the payment of some interest, a rate of 4 percent per annum simple interest shall be used. As an illustration of the meaning of simple interest, if a contract provides for payments of $6,000 in 3 equal installments of $2,000 plus 4 percent per annum simple interest, such installments of principal and interest being due 1, 2, and 3 years, respectively, from the date of the sale, the amount of interest due with the first installment is $80 ($2,000×0.04×1), the amount of interest due with the second installment is $160 ($2,000×0.04×2), and the amount of interest due with the third installment is $240 ($2,000×0.04×3). Section 483 shall not apply if the interest payments specified in a contract are at a rate of at least 4 percent per annum, whether simple or compounded. In all other cases, for purposes of determining, under section 483(c)(1)(B), whether there is total unstated interest, under a contract (not involving a purchaser

described in section 103), the following table, which provides for discounting payments at a 4 percent per annum simple interest rate, shall be used for computing the present value of a payment to which section 483 applies which is due under the contract, and the present value of any interest payment due under the contract:

PRESENT VALUE OF DEFERRED PAYMENT (4 PERCENT PER ANNUM SIMPLE INTEREST)

Number of months deferred		Present value of $1 at 4% simple interest
At least	But less than	
0	6	1.00000
6	9	.98039
9	15	.96154
15	21	.94340
21	27	.92593
27	33	.90909
33	39	.89286
39	45	.87719
45	51	.86207
51	57	.84746
57	63	.83333
63	69	.81967
69	75	.80645
75	81	.79365
81	87	.78125
87	93	.76923
93	99	.75758
99	105	.74627
105	111	.73529
111	117	.72464
117	123	.71429
123	129	.70423
129	135	.69444
135	141	.68493
141	147	.67568
147	153	.66667
153	159	.65789
159	165	.64935
165	171	.64103
171	177	.63291
177	183	.62500
183	189	.61728
189	195	.60976
195	201	.60241
201	207	.59524
207	213	.58824
213	219	.58140
219	225	.57471
225	231	.56818
231	237	.56180
237	243	.55556
243	249	.54945
249	255	.54348
255	261	.53763
261	267	.53191
267	273	.52632
273	279	.52083
279	285	.51546
285	291	.51020

PRESENT VALUE OF DEFERRED PAYMENT (4 PERCENT PER ANNUM SIMPLE INTEREST)—Continued

Number of months deferred		Present value of $1 at 4% simple interest
At least	But less than	
291	297	.50505
297	303	.50000
303	309	.49505
309	315	.49020
315	321	.48544
321	327	.48077
327	333	.47619
333	339	.47170
339	345	.46729
345	351	.46296
351	357	.45872
357	363	.45455
363	369	.45045
369	375	.44643
375	381	.44248
381	387	.43860
387	393	.43478
393	399	.43103
399	405	.42735
405	411	.42373
411	417	.42017
417	423	.41667
423	429	.41322
429	435	.40984
435	441	.40650
441	447	.40323
447	453	.40000
453	459	.39683
459	465	.39370
465	471	.39063
471	477	.38760
477	483	.38462
483	489	.38168
489	495	.37879
495	501	.37594
501	507	.37313
507	513	.37037
513	519	.36765
519	525	.36496
525	531	.36232
531	537	.35971
537	543	.35714
543	549	.35461
549	555	.35211
555	561	.34965
561	567	.34722
567	573	.34483
573	579	.34247
579	585	.34014
585	591	.33784
591	597	.33557
597	603	.33333
603	609	.33113
609	615	.32895
615	621	.32680
621	627	.32468
627	633	.32258
633	639	.32051

PRESENT VALUE OF DEFERRED PAYMENT (4 PERCENT PER ANNUM SIMPLE INTEREST)—Continued

Number of months deferred		Present value of $1 at 4% simple interest
At least	But less than	
639	645	.31847
645	651	.31646
651	657	.31447
657	663	.31250
663	669	.31056
669	675	.30864
675	681	.30675
681	687	.30488
687	693	.30303
693	699	.30120
699	705	.29940
705	711	.29762
711	717	.29586
717	723	.29412

To compute the present value of a payment, multiply the amount of the payment by the factor contained in the present value column for the appropriate number of months the payment is deferred. For example, the present value of an installment payment of $5,000 due 2 years (24 months) from the date of the sale would be $4,629.65 ($5,000×0.92593).

(c) *Effective date.* The provisions of section 483 and these temporary regulations shall apply to payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963, other than any sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963.

[T.D. 6720, 29 FR 4882, Apr. 7, 1964]

SUBCHAPTER B—ESTATE AND GIFT TAXES

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

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Section 20.7520–3 also issued under 26 U.S.C. 7520(c)(2).

Section 20.7520–4 also issued under 26 U.S.C. 7520(c)(2).

SOURCE: T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

INTRODUCTION

§ 20.0–1 Introduction.

(a) *In general.* (1) The regulations in this part (part 20, subchapter B, chapter I, title 26, Code of Federal Regulations) are designated ''Estate Tax Regulations.'' These regulations pertain to (i) the Federal estate tax imposed by chapter 11 of subtitle B of the Internal Revenue Code on the transfer of estates of decedents dying after August 16, 1954, and (ii) certain related administrative provisions of subtitle F of the Code. It should be noted that the application of many of the provisions of these regulations may be affected by the provisions of an applicable death tax convention with a foreign country. Unless otherwise indicated, references in the regulations to the ''Internal Revenue Code'' or the ''Code'' are references to the Internal Revenue Code of 1954, as amended, and references to a section or other provision of law are references to a section or other provision of the Internal Revenue Code of 1954, as amended. Unless otherwise provided, the Estate Tax Regulations are applicable to the estates of decedents dying after August 16, 1954, and supersede the regulations contained in part 81, subchapter B, chapter I, title 26, *Code of Federal Regulations* (1939) (Regulations 105, Estate Tax), as prescribed and made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, signed August 16, 1954 (19 FR 5167, Aug. 17, 1954). The regulations in this part do not reflect the amendments made by the Foreign Investors Tax Act of 1966 (80 Stat. 1539).

(2) Section 2208 makes the provisions of chapter 11 of the Code apply to the transfer of the estates of certain decedents dying after September 2, 1958, who were citizens of the United States and residents of a possession thereof at the time of death. Section 2209 makes the provisions of chapter 11 apply to the transfer of the estates of certain other decedents dying after September 14, 1960, who were citizens of the United States and residents of a possession thereof at the time of death. See §§ 20.2208–1 and 20.2209–1. Except as otherwise provided in §§ 20.2208–1 and 20.2209–1, the provisions of these regulations do not apply to the estates of such decedents.

(b) *Scope of regulations*—(1) *Estates of citizens or residents.* Subchapter A of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a citizen or a resident of the United States at the time of his death. A ''resident'' decedent is a decedent who, at the time of his death, had his domicile in the United States. The term ''United States'', as used in the estate tax regulations, includes only the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to their admission as States. See section 7701(a)(9). A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. For the meaning of the term ''citizen of the United States'' as applied in a case where the decedent was a resident of a possession of the United States, see § 20.2208–1. The regulations pursuant to subchapter A are set forth in §§ 20.2001–1 to 20.2056(d)–1.

(2) *Estates of nonresidents not citizens.* Subchapter B of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a nonresident not a citizen of the United States at the time of his death. A ''nonresident'' decedent is a decedent who, at the time of his death, had his domicile outside the United States under the principles set forth in subparagraph (1) of this paragraph. (See, however, section 2202 with respect to missionaries in foreign service.) The regulations pursuant to subchapter B are set forth in §§ 20.2101–1 to 20.2107–1.

(3) *Miscellaneous substantive provisions.* Subchapter C of Chapter 11 of the Code contains a number of miscellaneous substantive provisions. The regulations pursuant to subchapter C are set forth in §§ 20.2201–1 to 20.2209–1.

(4) *Procedure and administration provisions.* Subtitle F of the Internal Revenue Code contains some sections which are applicable to the Federal estate

tax. The regulations pursuant to those sections are set forth in §§ 20.6001–1 to 20.7101–1. Such regulations do not purport to be all the regulations on procedure and administration which are pertinent to estate tax matters. For the remainder of the regulations on procedure and administration which are pertinent to estate tax matters, see part 301 (Regulations on Procedure and Administration) of this chapter.

(c) *Arrangement and numbering.* Each section of the regulations in this part (other than this section and § 20.0–2) is designated by a number composed of the part number followed by a decimal point (20.); the section of the Internal Revenue Code which it interprets; a hyphen (-); and a number identifying the section. By use of these designations one can ascertain the sections of the regulations relating to a provision of the Code. For example, the regulations pertaining to section 2012 of the Code are designated § 20.2012–1.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 414, Jan. 19, 1961; T.D. 7238, 37 FR 28717, Dec. 29, 1972; T.D. 7296, 38 FR 34191, Dec. 12, 1973; T.D. 7665, 45 FR 6089, Jan. 25, 1980; T.D. 8522, 59 FR 9646, Mar. 1, 1994]

§ 20.0–2 General description of tax.

(a) *Nature of tax.* The Federal estate tax is neither a property tax nor an inheritance tax. It is a tax imposed upon the transfer of the entire taxable estate and not upon any particular legacy, devise, or distributive share. Escheat of a decedent's property to the State for lack of heirs is a transfer which causes the property to be included in the decedent's gross estate.

(b) *Method of determining tax; estate of citizen or resident*—(1) *In general.* Subparagraphs (2) to (5) of this paragraph contain a general description of the method to be used in determining the Federal estate tax imposed upon the transfer of the estate of a decedent who was a citizen or resident of the United States at the time of his death.

(2) *Gross estate.* The first step in determining the tax is to ascertain the total value of the decedent's gross estate. The value of the gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death. (For certain exceptions in the case of real property situated outside the United States, see paragraphs (a) and (c) of § 20.2031–1.) In addition, the gross estate may include property in which the decedent did not have an interest at the time of his death. A decedent's gross estate for Federal estate tax purposes may therefore be very different from the same decedent's estate for local probate purposes. Examples of items which may be included in a decedent's gross estate and not in his probate estate are the following: certain property transferred by the decedent during his lifetime without adequate consideration; property held jointly by the decedent and others; property over which the decedent had a general power of appointment; proceeds of certain policies of insurance on the decedent's life; annuities; and dower or curtesy of a surviving spouse or a statutory estate in lieu thereof. For a detailed explanation of the method of ascertaining the value of the gross estate, see sections 2031 through 2044, and the regulations thereunder.

(3) *Taxable estate.* The second step in determining the tax is to ascertain the value of the decedent's taxable estate. The value of the taxable estate is determined by subtracting from the value of the gross estate the authorized exemption and deductions. Under various conditions and limitations, deductions are allowable for expenses, indebtedness, taxes, losses, charitable transfers, and transfers to a surviving spouse. For a detailed explanation of the method of ascertaining the value of the taxable estate, see sections 2051 through 2056, and the regulations thereunder.

(4) *Gross estate tax.* The third step is the determination of the gross estate tax. This is accomplished by the application of certain rates to the value of the decedent's taxable estate. In this connection, see section 2001 and the regulations thereunder.

(5) *Net estate tax payable.* The final step is the determination of the net estate tax payable. This is done by subtracting from the gross estate tax the authorized credits against tax. Under certain conditions and limitations, credits are allowable for the following (computed in the order stated below):

(i) State death taxes paid in connection with the decedent's estate (section 2011);

(ii) Gift taxes paid on inter-vivos transfers by the decedent of property included in his gross estate (section 2012);

(iii) Foreign death taxes paid in connection with the decedent's estate (section 2014); and

(iv) Federal estate taxes paid on transfers of property to the decedent (section 2013).

Sections 25.2701–5 and 25.2702–6 of this chapter contain rules that provide additional adjustments to mitigate double taxation in cases where the amount of the decedent's gift was previously determined under the special valuation provisions of sections 2701 and 2702. For a detailed explanation of the credits against tax, see sections 201l through 2016 and the regulations thereunder.

(c) *Method of determining tax; estate of nonresident not a citizen.* In general, the method to be used in determining the Federal estate tax imposed upon the transfer of an estate of a decedent who was a nonresident not a citizen of the United States is similar to that described in paragraph (b) of this section with respect to the estate of a citizen or resident. Briefly stated, the steps are as follows: First, ascertain the sum of the value of that part of the decedent's ''entire gross estate'' which at the time of his death was situated in the United States (see §§ 20.2103–1 and 20.2014–1) and, in the case of an estate of an expatriate to which section 2107 applies, any amounts includible in his gross estate under section 2107(b) (see paragraph (b) of § 20.2107–1); second, determine the value of the taxable estate by subtracting from the amount determined under the first step the amount of the allowable deductions (see § 20.2106–1); third, compute the gross estate tax on the taxable estate (see § 20.2106–1); and fourth, subtract from the gross estate tax the total amount of any allowable credits in order to arrive at the net estate tax payable (see § 20.2102–1 and paragraph (c) of § 20.2107–1).

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6684, 28 FR 11408, Oct. 24, 1963; T.D. 7296, 38 FR 34191, Dec. 12, 1973; T.D. 8395, 57 FR 4254, Feb. 4, 1992]

ESTATES OF CITIZENS OR RESIDENTS

TAX IMPOSED

§ 20.2001–1 Rate of tax.

(a) The gross estate tax is computed by the application of progressively graduated rates to the value of the decedent's taxable estate in accordance with the following table:

TABLE FOR COMPUTATION OF GROSS ESTATE TAX

(A)—Taxable estate equal to or more than—	(B)—Taxable estate less than—	(C)—Tax on amount in column (A)	(D)—Rate of tax on excess over amount in column (A) (percent)
	$5,000	.....	3
$5,000	10,000	$150	7
10,000	20,000	500	11
20,000	30,000	1,600	14
30,000	40,000	3,000	18
40,000	50,000	4,800	22
50,000	60,000	7,000	25
60,000	100,000	9,500	28
100,000	250,000	20,700	30
250,000	500,000	65,700	32
500,000	750,000	145,700	35
750,000	1,000,000	233,200	37
1,000,000	1,250,000	325,700	39
1,250,000	1,500,000	423,200	42
1,500,000	2,000,000	528,200	45
2,000,000	2,500,000	753,200	49
2,500,000	3,000,000	998,200	53
3,000,000	3,500,000	1,263,200	56
3,500,000	4,000,000	1,543,200	59
4,000,000	5,000,000	1,838,200	63
5,000,000	6,000,000	2,468,200	67
6,000,000	7,000,000	3,138,200	70
7,000,000	8,000,000	3,838,200	73
8,000,000	10,000,000	4,568,200	76
10,000,000	.....	6,088,200	77

(b) The application of the table may be illustrated by the following example:

Example. The decedent died January 1, 1955, having a gross estate of $600,000. The exemption and authorized deductions amount to $75,000, thus leaving a taxable estate of $525,000. Reference to the table discloses that the specified amount in column (A) nearest to and less than the value of the decedent's taxable estate is $500,000. The tax upon this amount as indicated in column (C), is $145,700. The amount by which the taxable estate exceeds the same specified amount is $25,000. The tax upon this amount, computed at the rate of 35 percent indicated in column (D), is $8,750. Thus the total gross estate tax upon a taxable estate of $525,000 is $154,450. From this amount, the credits authorized by sections 2011 through 2014 are subtracted in order to determine the net estate tax payable.

§ 20.2002–1 Liability for payment of tax.

The Federal estate tax imposed both with respect to the estates of citizens or residents and with respect to estates of nonresidents not citizens is payable by the executor or administrator of the decedent's estate. This duty applies to the entire tax, regardless of the fact that the gross estate consists in part of property which does not come within the possession of the executor or administrator. If there is no executor or administrator appointed, qualified and acting in the United States, any person in actual or constructive possession of any property of the decedent is required to pay the entire tax to the extent of the value of the property in his possession. See section 2203, defining the term ''executor''. The personal liability of the executor or such other person is described in section 3467 of the Revised Statutes (31 U.S.C. 192) as follows:

> Every executor, administrator, or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid.

As used in said section, the word ''debt'' includes a beneficiary's distributive share of an estate. Thus, if the executor pays a debt due by the decedent's estate or distributes any portion of the estate before all the estate tax is paid, he is personally liable, to the extent of the payment or distribution, for so much of the estate tax as remains due and unpaid. In addition, section 6324(a)(2) provides that if the estate tax is not paid when due, then the spouse, transferee, trustee (except the trustee of an employee's trust which meets the requirements of section 401(a)), surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under section 2034 through 2042, is personally liable for the tax to the extent of the value, at the time of the decedent's death, of such property. See also the following related sections of the Internal Revenue Code: Section 2204, discharge of executor from personal liability; section 2205, reimbursement out of estate; sections 2206 and 2207, liability of life insurance beneficiaries and recipients of property over which decedent had power of appointment; sections 6321 through 6325, concerning liens for taxes; and section 6901(a)(1), concerning the liabilities of transferees and fiduciaries.

CREDITS AGAINST TAX

§ 20.2011–1 Credit for State death taxes.

(a) *In general.* A credit is allowed under section 2011 against the Federal estate tax for estate, inheritance, legacy or succession taxes actually paid to any State, Territory, or the District of Columbia, or, in the case of decedents dying before September 3, 1958, any possession of the United States (hereinafter referred to as ''State death taxes''). The credit, however, is allowed only for State death taxes paid (1) with respect to property included in the decedent's gross estate, and (2) with respect to the decedent's estate. The amount of the credit is subject to the limitation described in paragraph (b) of this section. It is subject to further limitations described in § 20.2011–2 if a deduction is allowed under section 2053(d) for State death taxes paid with respect to a charitable gift. See paragraph (a) of § 20.2014–1 as to the allowance of a credit for death taxes paid to a possession of the United States in a case where the decedent died after September 2, 1958.

(b) *Amount of credit.* (1) If the decedent's taxable estate does not exceed $40,000, the credit for State death taxes is zero. If the decedent's taxable estate does exceed $40,000, the credit for State death taxes is limited to an amount computed in accordance with the following table:

TABLE FOR COMPUTATION OF MAXIMUM CREDIT FOR STATE DEATH TAXES

(A)—Taxable estate equal to or more than—	(B)—Taxable estate less than—	(C)—Credit on amount in column (A)	(D)—Rates of credit on excess over amount in column (A) (percent)
$40,000	$90,000	.....	0.8
90,000	140,000	$400	1.6
140,000	240,000	1,200	2.4
240,000	440,000	3,600	3.2
440,000	640,000	10,000	4.0
640,000	840,000	18,000	4.8
840,000	1,040,000	27,600	5.6
1,040,000	1,540,000	38,800	6.4
1,540,000	2,040,000	70,800	7.2
2,040,000	2,540,000	106,800	8.0
2,540,000	3,040,000	146,800	8.8
3,040,000	3,540,000	190,800	9.6
3,540,000	4,040,000	238,800	10.4
4,040,000	5,040,000	290,800	11.2
5,040,000	6,040,000	402,800	12.0
6,040,000	7,040,000	522,800	12.8
7,040,000	8,040,000	650,800	13.6
8,040,000	9,040,000	786,800	14.4
9,040,000	10,040,000	930,800	15.2
10,040,000	.....	1,082,800	16.0

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) The decedent died January 1, 1955, leaving a taxable estate of $150,000. On January 1, 1956, inheritance taxes totaling $2,500 were actually paid to a State with respect to property included in the decedent's gross estate. Reference to the table discloses that the specified amount in column (A) nearest to but less than the value of the decedent's taxable estate is $140,000. The maximum credit in respect of this amount, as indicated in column (C), is $1,200. The amount by which the taxable estate exceeds the same specified amount is $10,000. The maximum credit in respect of this amount, computed at the rate of 2.4 percent indicated in column (D), is $240. Thus, the maximum credit in respect of the decedent's taxable estate of $150,000 is $1,440, even though $2,500 in inheritance taxes was actually paid to the State.

(ii) If, in subdivision (i) of this example, the amount actually paid to the State was $950, the credit for State death taxes would be limited to $950. If, in subdivision (i) of this example, the decedent's taxable estate was $35,000, no credit for State death taxes would be allowed.

(c) *Miscellaneous limitations and conditions to credit*—(1) *Period of limitations.* The credit for State death taxes is limited under section 2011(c) to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the estate tax return for the decedent's estate. If, however, a petition has been filed with the Tax Court of the United States for the redetermination of a deficiency within the time prescribed in section 6213(a), the credit is limited to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the return or within 60 days after the decision of the Tax Court becomes final, whichever period is the last to expire. Similarly, if an extension of time has been granted under section 6161 for payment of the tax shown on the return, or of a deficiency, the credit is limited to those taxes which were actually paid and for which a credit was claimed within four years after the filing of the return, or before the date of the expiration of the period of the extension, whichever period is last to expire. If a claim for refund or credit of an overpayment of the Federal estate tax is filed within the time prescribed in section 6511, the credit for State death taxes is limited to such taxes as were actually paid and credit therefor claimed within four years after the filing of the return or before the expiration of 60 days from the date of mailing by certified or registered mail by the district director to the taxpayer of a notice of disallowance of any part of the claim, or before the expiration of 60 days after a decision by any court of competent jurisdiction becomes final with respect to a timely suit instituted upon the claim, whichever period is the last to expire. See section 2015 for the applicable period of limitations for credit for State death taxes on reversionary or remainder interests if an election is made under section 6163(a) to postpone payment of the estate tax attributable to reversionary or remainder interests. If a claim for refund based on the credit for State death taxes is filed within the applicable period described in this subparagraph, a refund may be made despite the general limitation provisions of sections 6511 and 6512. Any refund based on the credit described in this section shall be made without interest.

(2) *Submission of evidence.* Before the credit for State death taxes is allowed, evidence that such taxes have been paid must be submitted to the district director. The district director may require the submission of a certificate

from the proper officer of the taxing State, Territory, or possession of the United States, or the District of Columbia, showing: (i) The total amount of tax imposed (before adding interest and penalties and before allowing discount); (ii) the amount of any discount allowed; (iii) the amount of any penalties and interest imposed or charged; (iv) the total amount actually paid in cash; and (v) the date or dates of payment. If the amount of these taxes has been redetermined, the amount finally determined should be stated. The required evidence should be filed with the return, but if that is not convenient or possible, then it should be submitted as soon thereafter as practicable. The district director may require the submission of such additional proof as is deemed necessary to establish the right to the credit. For example, he may require the submission of a certificate of the proper officer of the taxing jurisdiction showing (vi) whether a claim for refund of any part of the State death tax is pending and (vii) whether a refund of any part thereof has been authorized, and if a refund has been made, its date and amount, and a description of the property or interest in respect of which the refund was made. The district director may also require an itemized list of the property in respect of which State death taxes were imposed certified by the officer having custody of the records pertaining to those taxes. In addition, he may require the executor to submit a written statement (containing a declaration that it is made under penalties of perjury) stating whether, to his knowledge, any person has instituted litigation or taken an appeal (or contemplates doing so), the final determination of which may affect the amount of those taxes. See section 2016 concerning the redetermination of the estate tax if State death taxes claimed as credit are refunded.

(d) *Definition of ''basic estate tax''.* Section 2011(d) provides definitions of the terms ''basic estate tax'' and ''additional estate tax'', used in the Internal Revenue Code of 1939, and ''estate tax imposed by the Revenue Act of 1926'', for the purpose of supplying a means of computing State death taxes under local statutes using those terms, and for use in determining the exemption provided for in section 2201 for estates of certain members of the Armed Forces. See section 2011(e)(3) for a modification of these definitions if a deduction is allowed under section 2053(d) for State death taxes paid with respect to a charitable gift.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6526, 26 FR 414, Jan. 19, 1961]

§ 20.2011–2 Limitation on credit if a deduction for State death taxes is allowed under section 2053(d).

If a deduction is allowed under section 2053(d) for State death taxes paid with respect to a charitable gift, the credit for State death taxes is subject to special limitations. Under these limitations, the credit cannot exceed the least of the following:

(a) The amount of State death taxes paid other than those for which a deduction is allowed under section 2053(d);

(b) The amount indicated in section 2011(b) to be the maximum credit allowable with respect to the decedent's taxable estate; or

(c) An amount, A, which bears the same ratio to B (the amount which would be the maximum credit allowable under section 2011(b) if the deduction under section 2053(d) for State death taxes were not allowed in computing the decedent's taxable estate) as C (the amount of State death taxes paid other than those for which a deduction is allowed under section 2053(d)) bears to D (the total amount of State death taxes paid). For the purpose of this computation, in determining what the decedent's taxable estate would be if the deduction for State death taxes under section 2053(d) were not allowed, adjustment must be made for the decrease in the deduction for charitable gifts under section 2055 or 2106(a)(2) (for estates of nonresidents not citizens) by reason of any increase in Federal estate tax which would be charged against the charitable gifts.

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

Example. The decedent died January 1, 1955, leaving a gross estate of $925,000. Expenses, indebtedness, etc., amounted to $25,000. The decedent bequeathed $400,000 to his son with the direction that the son bear the State

death taxes on the bequest. The residuary estate was left to a charitable organization. Except as noted above, all Federal and State death taxes were payable out of the residuary estate. The State imposed death taxes of $60,000 on the son's bequest and death taxes of $75,000 on the bequest to charity. No death taxes were imposed by a foreign country with respect to any property in the gross estate. The decedent's taxable estate (determined without regard to the limitation imposed by section 2011(e)(2)(B) is computed as follows:

Gross estate				$925,000.00
Expenses, indebtedness, etc.			$25,000.00	
Exemption			60,000.00	
Deduction under section 2053(d)			75,000.00	
Charitable deduction:				
Gross estate		$925,000.00		
Expenses, etc	$25,000.00			
Bequest to son	400,000.00			
State death tax paid from residue	75,000.00			
Federal estate tax paid from residue	122,916.67	622,916.67	302,083.33	462,083.33
Taxable estate				462,916.67

If the deduction under section 2053(d) were not allowed, the decedent's taxable estate would be computed as follows:

Gross estate				$925,000.00
Expenses, indebtedness, etc.			$25,000.00	
Exemption			60,000.00	
Charitable deduction:				
Gross estate		$925,000.00		
Expenses, etc	$25,000.00			
Bequest to son	400,000.00			
State death tax paid from residue	75,000.00			
Federal estate tax paid from residue	155,000.00	655,000.00	270,000.00	355,000.00
Taxable estate				570,000.00

On a taxable estate of $570,000, the maximum credit allowable under section 2011(b) would be $15,200. Under these facts, the credit for State death taxes is determined as follows:

(1) Amount of State death taxes paid other than those for which a deduction is allowed under section 2053(d) ($135,000 – $75,000)	$60,000.00
(2) Amount indicated in section 2011(b) to be the maximum credit allowable with respect to the decedent's taxable estate of $462,916.67	10,916.67
(3) Amount determined by use of the ratio described in paragraph (c) above [($60,000÷$135,000)×$15,200]	6,755.56
(4) Credit for State death taxes (least of subparagraphs (1) through (3) above)	6,755.56

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6600, 27 FR 4983, May 29, 1962]

§ 20.2012–1 Credit for gift tax.

(a) *In general.* With respect to gifts made before 1977, a credit is allowed under section 2012 against the Federal estate tax for gift tax paid under chapter 12 of the Internal Revenue Code, or corresponding provisions of prior law, on a gift by the decedent of property subsequently included in the decedent's gross estate. The credit is allowable even though the gift tax is paid after the decedent's death and the amount of the gift tax is deductible from the gross estate as a debt of the decedent.

(b) *Limitations on credit.* The credit for gift tax is limited to the smaller of the following amounts:

(1) The amount of gift tax paid on the gift computed as set forth in paragraph (c) of this section, or

(2) The amount of the estate tax attributable to the inclusion of the gift in the gross estate, computed as set forth in paragraph (d) of this section.

When more than one gift is included in the gross estate, a separate computation of the two limitations on the credit is to be made for each gift.

(c) *''First limitation''.* The amount of the gift tax paid on the gift is the ''first limitation''. Thus, if only one gift was made during a certain calendar quarter, or calendar year if the gift was made before January 1, 1971, and the gift is wholly included in the decedent's gross estate for the purpose

of the estate tax, the credit with respect to the gift is limited to the amount of the gift tax paid for that calendar quarter or calendar year. On the other hand, if more than one gift was made during a certain calendar quarter or calendar year, the credit with respect to any such gift which is included in the decedent's gross estate is limited under section 2012(d) to an amount, A, which bears the same ratio to B (the total gift tax paid for that calendar quarter or calendar year) as C (the ''amount of the gift,'' computed as described below) bears to D (the total taxable gifts for the calendar quarter or the calendar year, computed without deduction of the gift tax specific exemption). Stated algebraically, the ''first limitation'' (A) equals:

''Amount of the gift'' (C) ÷ Total taxable gifts, plus specific exemption allowed (D) × Total gift tax paid (B).

For purposes of the ratio stated above, the ''amount of the gift'' referred to as factor ''C'' is the value of the gift reduced by any portion excluded or deducted under sections 2503(b) (annual exclusion), 2522 (charitable deduction), or 2523 (marital deduction) of the Internal Revenue Code or corresponding provisions of prior law. In making the computations described in this paragraph, the values to be used are those finally determined for the purpose of the gift tax, irrespective of the values determined for the purpose of the estate tax. A similar computation is made in case only a portion of any gift is included in the decedent's gross estate. The application of this paragraph may be illustrated by the following example:

Example. The donor made gifts during the calendar year 1955 on which a gift tax was determined as shown below:

Gift of property to son on February 1		$13,000
Gift of property to wife on May 1		86,000
Gift of property to charitable organization on May 15		10,000
Total gifts		109,000
Less exclusions ($3,000 for each gift)		9,000
Total included amount of gifts		100,000
Marital deduction (for gift to wife)	$43,000	
Charitable deduction	7,000	
Specific exemption ($30,000 less $20,000 used in prior years)	10,000	
Total deductions		60,000
Taxable gifts		40,000
Total gift tax paid for calendar year 1955		3,600

The donor's gift to his wife was made in contemplation of death and was thereafter included in his gross estate. Under the ''first limitation'', the credit with respect to that gift cannot exceed:

[$86,000 − $3,000 − $43,000 (gift to wife, less annual exclusion and marital deduction)] ÷ [$40,000 + $10,000 (taxable gifts, plus specific exemption allowed)] × $3,600 (total gift tax paid) = $2,880.

(d) *''Second limitation''.* (1) The amount of the estate tax attributable to the inclusion of the gift in the gross estate is the ''second limitation''. Thus, the credit with respect to any gift of property included in the gross estate is limited to an amount, E, which bears the same ratio to F (the gross estate tax, reduced by any credit for State death taxes under section 2011) as G (the ''value of the gift'', computed as described in subparagraph (2) of this paragraph) bears to H (the value of entire gross estate, reduced by the total deductions allowed under sections 2055 or 2106(a)(2) (charitable deduction) and 2056 (marital deduction)). Stated algebraically, the ''second limitation'' (E) equals:

''Value of the gift'' (G) ÷ Value of gross estate, less marital and charitable deductions (H) × Gross estate tax, less credit for State death taxes (F).

(2) For purposes of the ratio stated in subparagraph (1) of this paragraph, the ''value of the gift'' referred to as factor ''G'' is the value of the property transferred by gift and included in the gross estate, as determined for the purpose of the gift tax or for the purpose of the estate tax, whichever is lower, and adjusted as follows:

(i) The appropriate value is reduced by all or a portion of any annual exclusion allowed for gift tax purposes under section 2503(b) of the Internal Revenue Code or corresponding provisions of prior law. If the gift tax value is lower than the estate tax value, it is reduced by the entire amount of the exclusion. If the estate tax value is lower than the gift tax value, it is reduced by an amount which bears the same ratio to the estate tax value as the annual exclusion bears to the total value of the

property as determined for gift tax purposes. To illustrate: In 1955, a donor, in contemplation of death, transferred certain property to his five children which was valued at $300,000, for the purpose of the gift tax. Thereafter, the same property was included in his gross estate at a value of $270,000. In computing his gift tax, the donor was allowed annual exclusions totalling $15,000. The reduction provided for in this subdivision is:

$15,000 (annual exclusions allowed) ÷ $300,000 (value of transferred property for the purpose of the gift tax) × $270,000 (value of transferred property for the purpose of the estate tax) = $13,500.

(ii) The appropriate value is further reduced if any portion of the value of the property is allowed as a marital deduction under section 2056 or as a charitable deduction under section 2055 or section 2106(a)(2) (for estates of nonresidents not citizens). The amount of the reduction is an amount which bears the same ratio to the value determined under subdivision (i) of this subparagraph as the portion of the property allowed as a marital deduction or as a charitable deduction bears to the total value of the property as determined for the purpose of the estate tax. Thus, if a gift is made solely to the decedent's surviving spouse and is subsequently included in the decedent's gross estate as having been made in contemplation of death, but a marital deduction is allowed under section 2056 for the full value of the gift, no credit for gift tax on the gift will be allowed since the reduction under this subdivision together with the reduction under subdivision (i) of this subparagraph will have the effect of reducing the factor ''G'' of the ratio in subparagraph (1) of this paragraph to zero.

(e) *Credit for ''split gifts''.* If a decedent made a gift of property which is thereafter included in his gross estate, and, under the provisions of section 2513 of the Internal Revenue Code of 1954 or section 1000(f) of the Internal Revenue Code of 1939, the gift was considered as made one-half by the decedent and one-half by his spouse, credit against the estate tax is allowed for the gift tax paid with respect to both halves of the gift. The ''first limitation'' is to be separately computed with respect to each half of the gift in accordance with the principles stated in paragraph (c) of this section. The ''second limitation'' is to be computed with respect to the entire gift in accordance with the principles stated in paragraph (d) of this section. To illustrate: A donor, in contemplation of death, transferred property valued at $106,000 to his son on January 1, 1955, and he and his wife consented that the gift should be considered as made one-half by him and one-half by her. The property was thereafter included in the donor's gross estate. Under the ''first limitation'', the amount of the gift tax of the donor paid with respect to the one-half of the gift considered as made by him is determined to be $11,250, and the amount of the gift tax of his wife paid with respect to the one-half of the gift considered as made by her is determined to be $1,200. Under the ''second limitation'', the amount of the estate tax attributable to the property is determined to be $28,914. Therefore, the credit for gift tax allowed is $12,450 ($11,250 plus $1,200).

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28718, Dec. 29, 1972; T.D. 8522, 59 FR 9646, Mar. 1, 1994]

§ 20.2013–1 Credit for tax on prior transfers.

(a) *In general.* A credit is allowed under section 2013 against the Federal estate tax imposed on the present decedent's estate for Federal estate tax paid on the transfer of property to the present decedent from a transferor who died within ten years before, or within two years after, the present decedent's death. See § 20.2013–5 for definition of the terms ''property'' and ''transfer''. There is no requirement that the transferred property be identified in the estate of the present decedent or that the property be in existence at the time of the decedent's death. It is sufficient that the transfer of the property was subjected to Federal estate tax in the estate of the transferor and that the transferor died within the prescribed period of time. The executor must submit such proof as may be requested by the district director in order to establish the right of the estate to the credit.

(b) *Limitations on credit.* The credit for tax on prior transfers is limited to the smaller of the following amounts:

(1) The amount of the Federal estate tax attributable to the transferred property in the transferor's estate, computed as set forth in § 20.2013–2; or

(2) The amount of the Federal estate tax attributable to the transferred property in the decedent's estate, computed as set forth in § 20.2013–3.

Rules for valuing property for purposes of the credit are contained in § 20.2013–4.

(c) *Percentage reduction.* If the transferor died within the two years before, or within the two years after, the present decedent's death, the credit is the smaller of the two limitations described in paragraph (b) of this section. If the transferor predeceased the present decedent by more than two years, the credit is a certain percentage of the smaller of the two limitations described in paragraph (b) of this section, determined as follows:

(1) 80 percent, if the transferor died within the third or fourth years preceding the present decedent's death;

(2) 40 percent, if the transferor died within the fifth or sixth years preceding the present decedent's death;

(3) 40 percent, if the transferor died within the seventh or eighth years preceding the present decedent's death; and

(4) 20 percent, if the transferor died within the ninth or tenth years preceding the present decedent's death.

The word ''within'' as used in this paragraph means ''during''. Therefore, if a death occurs on the second anniversary of another death, the first death is considered to have occurred within the two years before the second death. If the credit for tax on prior transfers relates to property received from two or more transferors, the provisions of this paragraph are to be applied separately with respect to the property received from each transferor. See paragraph (d) of example (2) in § 20.2013–6.

(d) *Examples.* For illustrations of the application of this section, see examples (1) and (2) set forth in § 20.2013–6.

§ 20.2013–2 "First limitation".

(a) The amount of the Federal estate tax attributable to the transferred property in the transferor's estate is the ''first limitation.'' Thus, the credit is limited to an amount, A, which bears the same ratio to B (the ''transferor's adjusted Federal estate tax'', computed as described in paragraph (b) of this section) as C (the value of the property transferred (see § 20.2013–4)) bears to D (the ''transferor's adjusted taxable estate'', computed as described in paragraph (c) of this section). Stated algebraically, the ''first limitation'' (A) equals:

Value of transferred property (C) ÷ ''Transferor's adjusted taxable estate'' (D) × ''Transferor's adjusted Federal estate tax'' (B).

(b) For purposes of the ratio stated in paragraph (a) of this section, the ''transferor's adjusted Federal estate tax'' referred to as factor ''B'' is the amount of the Federal estate tax paid with respect to the transferor's estate plus:

(1) Any credit allowed the transferor's estate for gift tax under section 2012, or the corresponding provisions of prior law; and

(2) Any credit allowed the transferor's estate, under section 2013, for tax on prior transfers, but only if the transferor acquired property from a person who died within 10 years before the death of the present decedent.

(c)(1) For purposes of the ratio stated in paragraph (a) of this section, the ''transferor's adjusted taxable estate'' referred to as factor ''D'' is the amount of the transferor's taxable estate (or net estate) decreased by the amount of any ''death taxes'' paid with respect to his gross estate and increased by the amount of the exemption allowed in computing his taxable estate (or net estate). The amount of the transferor's taxable estate (or net estate) is determined in accordance with the provisions of § 20.2051–1 in the case of a citizen or resident of the United States or of § 20.2106–1 in the case of a nonresident not a citizen of the United States (or the corresponding provisions of prior regulations). The term ''death taxes'' means the Federal estate tax

plus all other estate, inheritance, legacy, succession, or similar death taxes imposed by, and paid to, any taxing authority, whether within or without the United States. However, only the net amount of such taxes paid is taken into consideration.

(2) The amount of the exemption depends upon the citizenship and residence of the transferor at the time of his death. Except in the case of a decedent described in section 2209 (relating to certain residents of possessions of the United States who are considered nonresidents not citizens), if the decedent was a citizen or resident of the United States, the exemption is the $60,000 authorized by section 2052 (or the corresponding provisions of prior law). If the decedent was a nonresident not a citizen of the United States, or is considered under section 2209 to have been such a nonresident, the exemption is the $30,000 or $2,000, as the case may be, authorized by section 2106(a)(3) (or the corresponding provisions of prior law), or such larger amount as is authorized by section 2106(a)(3)(B) or may have been allowed as an exemption pursuant to the prorated exemption provisions of an applicable death tax convention. See § 20.2052–1 and paragraph (a)(3) of § 20.2106–1.

(d) If the credit for tax on prior transfers relates to property received from two or more transferors, the provisions of this section are to be applied separately with respect to the property received from each transferor. See paragraph (b) of example (2) in § 20.2013–6.

(e) For illustrations of the application of this section, see examples (1) and (2) set forth in § 20.2013–6.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34191, Dec. 12, 1973]

§ 20.2013–3 "Second limitation".

(a) The amount of the Federal estate tax attributable to the transferred property in the present decedent's estate is the ''second limitation''. Thus, the credit is limited to the difference between—

(1) The net estate tax payable (see paragraph (b)(5) or (c), as the case may be, of § 20.0–2) with respect to the present decedent's estate, determined without regard to any credit for tax on prior transfers under section 2013 or any credit for foreign death taxes claimed under the provisions of a death tax convention, and

(2) The net estate tax determined as provided in subparagraph (1) of this paragraph but computed by subtracting from the present decedent's gross estate the value of the property transferred (see § 20.2013–4), and by making only the adjustment indicated in paragraph (b) of this section if a charitable deduction is allowable to the estate of the present decedent.

(b) If a charitable deduction is allowable to the estate of the present decedent under the provisions of section 2055 or section 2106 (a)(2) (for estates of nonresidents not citizens), for purposes of determining the tax described in paragraph (a)(2) of this section, the charitable deduction otherwise allowable is reduced by an amount, E, which bears the same ratio to F (the charitable deduction otherwise allowable) as G (the value of the transferred property (see § 20.2013–4)) bears to H (the value of the present decedent's gross estate reduced by the amount of the deductions for expenses, indebtedness, taxes, losses, etc., allowed under the provisions of sections 2053 and 2054 or section 2106(a)(1) (for estates of nonresidents not citizens)). See paragraph (c)(2) of example (1) and paragraph (c)(2) of example (2) in § 20.2013–6.

(c) If the credit for tax on prior transfers relates to property received from two or more transferors, the property received from all transferors is aggregated in determining the limitation on credit under this section (the ''second limitation''). However, the limitation so determined is apportioned to the property received from each transferor in the ratio that the property received from each transferor bears to the total property received from all transferors. See paragraph (c) of example (2) in § 20.2013–6.

(d) For illustrations of the application of this section, see examples (1) and (2) set forth in § 20.2013–6.

[T.D. 6296, 23 FR 4529, June 24, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7296, 38 FR 34191, Dec. 12, 1973]