Title 26—Internal Revenue

(This book contains part 1, §§1.641 to 1.850)

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

(Part 1, §§ 1.641 to 1.850)

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

SUBCHAPTER A—INCOME TAX (CONTINUED)

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

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

SUBCHAPTER A—INCOME TAX (CONTINUED)

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

Section 1.642(c)–6 also issued under 26 U.S.C. 642(c)(5).

Section 1.643(a)–8 also issued under 26 U.S.C. 643(a)(7).

Section 1.643(h)–1 also issued under 26 U.S.C. 643(a)(7).
Section 1.642(c)–6A also issued under 26 U.S.C. 642(c)(5).
Section 1.645–1 also issued under 26 U.S.C. 645.
Sections 1.663(c)–1, 1.663(c)–2, 1.663(c)–3, 1.663(c)–4, 1.663(c)–5, and 1.663(c)–6 also issued under 26 U.S.C. 663(c).
Section 1.664–1 also issued under 26 U.S.C. 664(a).
Section 1.664–2 also issued under 26 U.S.C. 664(a).
Section 1.664–3 also issued under 26 U.S.C. 664(a).
Section 1.664–4 also issued under 26 U.S.C. 664(a).
Section 1.664–4A also issued under 26 U.S.C. 664(a).
Section 1.671–2 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6).
Section 1.672(f)–1 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6).
Section 1.672(f)–2 also issued under 26 U.S.C. 643(a)(7) and 672(f)(3) and (6).
Section 1.672(f)–3 also issued under 26 U.S.C. 643(a)(7) and 672(f)(2) and (6).
Section 1.672(f)–4 also issued under 26 U.S.C. 643(a)(7) and 672(f)(4) and (6).
Section 1.672(f)–5 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6).
Section 1.679–1 also issued under 26 U.S.C. 643(a)(7) and 679(d).
Section 1.679–2 also issued under 26 U.S.C. 643(a)(7) and 679(d).
Section 1.679–3 also issued under 26 U.S.C. 643(a)(7) and 679(d).
Section 1.679–4 also issued under 26 U.S.C. 643(a)(7), 679(a)(3) and 679(d).
Section 1.679–5 also issued under 26 U.S.C. 643(a)(7) and 679(d).
Section 1.679–6 also issued under 26 U.S.C. 643(a)(7) and 679(d).
Section 1.684–1 also issued under 26 U.S.C. 643(a)(7) and 684(a).
Section 1.684–2 also issued under 26 U.S.C. 643(a)(7) and 684(a).
Section 1.684–3 also issued under 26 U.S.C. 643(a)(7) and 684(a).
Section 1.684–4 also issued under 26 U.S.C. 643(a)(7) and 684(a).
Section 1.684–5 also issued under 26 U.S.C. 643(a)(7) and 684(a).
Section 1.701–2 also issued under 26 U.S.C. 701 through 761.
Section 1.704–3 also issued under 26 U.S.C. 704(c).
Section 1.704–3T also issued under 26 U.S.C. 704(c).
Section 1.704–4 also issued under 26 U.S.C. 704(c).
Section 1.705–2 also issued under 26 U.S.C. 705 and 1032.
Section 1.706–1T also issued under 26 U.S.C. 706(b).
Section 1.706–3T also issued under 26 U.S.C. 444(f).
Sections 1.707–2 through 1.707–9 also issued under 26 U.S.C. 707(a)(2).
Section 1.721–1 also issued under 26 U.S.C. 721.
Section 1.731–2 also issued under 26 U.S.C. 731(c).
Section 1.732–1 also issued under 26 U.S.C. 732.
Section 1.732–2 also issued under 26 U.S.C. 732.
Section 1.732–3 also issued under 26 U.S.C. 732(f).
Section 1.734–1 also issued under 26 U.S.C. 734.
Section 1.743–1 also issued under 26 U.S.C. 743.
Section 1.751–1 also issued under 26 U.S.C. 751.
Section 1.755–1 also issued under 26 U.S.C. 755.
Section 1.755–2 also issued under 26 U.S.C. 755 and 26 U.S.C. 1060.
Section 1.761–2 also issued under 26 U.S.C. 446(b) and 26 U.S.C. 761(a).
Section 1.807–2 also issued under 26 U.S.C. 817A(e).
Section 1.809–10 also issued under 26 U.S.C. 809(b)(2) and (g)(3).
Section 1.811–3 also issued under 26 U.S.C. 817A(e).
Section 1.812–9 also issued under 26 U.S.C. 817A(e).
Section 1.817A–1 also issued under 26 U.S.C. 817A(e).
Section 1.832–4 also issued under 26 U.S.C. 832(b)(5)(A).
Sections 1.846–1 through 1.846–4 also issued under 26 U.S.C. 846.
Section 1.848–2 also issued under 26 U.S.C. 845(b) and 26 U.S.C. 848(d)(4)(B).
Section 1.848–3 also issued under 26 U.S.C. 848(d)(4)(B).

SOURCE: T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

ESTATES, TRUSTS, AND BENEFICIARIES

General Rules for Taxation of Estates and Trusts

§ 1.641 [Reserved]

§ 1.641(a)–0 Scope of subchapter J.

(a) *In general.* Subchapter J (sections 641 and following), chapter 1 of the Code, deals with the taxation of income of estates and trusts and their beneficiaries, and of income in respect of decedents. Part I of subchapter J contains general rules for taxation of estates and trusts (subpart A), specific rules relating to trusts which distribute current income only (subpart B), estates and trusts which may accumulate income or which distribute corpus (subpart C), treatment of excess distributions by trusts (subpart D), grantors and other persons treated as substantial owners (subpart E), and miscellaneous provisions relating to limitations on charitable deductions, income of an estate or trust in case of divorce, and taxable years to which the provisions of subchapter J are applicable (subpart F). Part I has no application to any organization which is not to be classified for tax purposes as a trust under the classification rules of §§ 301.7701–2, 301.7701–3, and 301.7701–4 of this chapter (Regulations on Procedure and Administration). Part II of subchapter J relates to the treatment of income in respect of decedents. However, the provisions of subchapter J do not apply to employee trusts subject to subchapters D and F, chapter 1 of the Code, and common trust funds subject to subchapter H, chapter 1 of the Code.

(b) *Scope of subparts A, B, C, and D.* Subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code, relate to the taxation of estates and trusts and their beneficiaries. These subparts have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Code, as that of the grantor or others treated as its substantial owners. See subpart E (section 671 and following), Part I, subchapter J, chapter 1 of the Code, and the regulations thereunder for rules for the treatment of any portion of a trust where the grantor (or another person) is treated as the substantial owner. So-called alimony trusts are treated under subparts A, B, C, and D, except to the extent otherwise provided in section 71 or section 682. These subparts have no application to beneficiaries of nonexempt employees' trusts. See section 402(b) and the regulations thereunder.

(c) *Multiple trusts.* Multiple trusts that have:

(1) No substantially independent purposes (such as independent dispositive purposes),

(2) The same grantor and substantially the same beneficiary, and

(3) The avoidance or mitigation of (*i*) the progressive rates of tax (including mitigation as a result of deferral of tax) or *(ii)* the minimum tax for tax preferences imposed by section 56 as their principal purpose,

shall be consolidated and treated as one trust for the purposes of subchapter J.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 731, Jan. 17, 1969; T.D. 7204, 37 FR 17158, Aug. 25, 1972]

§ 1.641(a)–1 Imposition of tax; application of tax.

For taxable years beginning after December 31, 1970, section 641 prescribes that the taxes imposed by section 1(d), as amended by the Tax Reform Act of 1969, shall apply to the income of estates or of any kind of property held in trust. For taxable years ending before January 1, 1971, section 641 prescribes that the taxes imposed upon individuals by chapter 1 of the Code apply to the income of estates or of any kind of property held in trust. The rates of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trust.

[T.D. 7117, 36 FR 9421, May 25, 1971]

§ 1.641(a)–2 Gross income of estates and trusts.

The gross income of an estate or trust is determined in the same manner as that of an individual. Thus, the gross income of an estate or trust consists of all items of gross income received during the taxable year, including:

(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(b) Income accumulated or held for future distribution under the terms of the will or trust;

(c) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(d) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(e) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated. The several classes of income enumerated in this section do not exclude others which also may come within the general purposes of section 641.

§ 1.641(b)–1 Computation and payment of tax; deductions and credits of estates and trusts.

Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts. However, there are special rules for the computation of certain deductions and for the allocation between the estate or trust and the beneficiaries of certain credits and deductions. See section 642 and the regulations thereunder. In addition, an estate or trust is allowed to deduct, in computing its taxable income, the deductions provided by sections 651 and 661 and regulations thereunder, relating to distributions to beneficiaries.

§ 1.641(b)–2 Filing of returns and payment of the tax.

(a) The fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934 (31 U. S. C. 192). Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. See section 6901. The same considerations apply to trusts.

(b) The estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or a corporation in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or of a trust. See section 6012(b) (2) and (3) for provisions relating to the obligation of the fiduciary with respect to returns of such persons.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6580, 26 FR 11486, Dec. 5, 1961]

§ 1.641(b)–3 Termination of estates and trusts.

(a) The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary). Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

(b) Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(c)(1) Except as provided in subparagraph (2) of this paragraph, during the period between the occurrence of an event which causes a trust to terminate and the time when the trust is considered as terminated under this section, whether or not the income and the excess of capital gains over capital losses of the trust are to be considered as amounts required to be distributed currently to the ultimate distributee for the year in which they are received depends upon the principles stated in §1.651(a)–2. See §1.663–1 *et seq.* for application of the separate share rule.

(2)(i) Except in cases to which the last sentence of this subdivision applies, for taxable years of a trust ending before September 1, 1957, subparagraph (1) of this paragraph shall not apply and the rule of subdivision (ii) of this subparagraph shall apply unless the trustee elects to have subparagraph (1) of this paragraph apply. Such election shall be made by the trustee in a statement filed on or before April 15, 1959, with the district director with whom such trust's return for any such taxable year was filed. The election provided by this subdivision shall not be available if the treatment given the income and the excess of capital gains over capital losses for taxable years for which returns have been filed was consistent with the provisions of subparagraph (1) of this paragraph.

(ii) The rule referred to in subdivision (i) of this subparagraph is as follows: During the period between the occurrence of an event which causes a trust to terminate and the time when a trust is considered as terminated under this section, the income and the excess of capital gains over capital losses of the trust are in general considered as amounts required to be distributed for the year in which they are received. For example, a trust instrument provides for the payment of income to A during her life, and upon her death for the payment of the corpus to B. The trust reports on the basis of the calendar year. A dies on November 1, 1955, but no distribution is made to B until January 15, 1956. The income of the trust and the excess of capital gains over capital losses for the entire year 1955, to the extent not paid, credited, or required to be distributed to A or A's estate, are treated under sections 661 and 662 as amounts required to be distributed to B for the year 1955.

(d) If a trust or the administration or settlement of an estate is considered terminated under this section for Federal income tax purposes (as for instance, because administration has been unduly prolonged), the gross income, deductions, and credits of the estate or trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9032, 67 FR 78376, Dec. 24, 2002]

§ 1.641(c)–0 Table of contents.

This section lists the major captions contained in § 1.641(c)–1.

§ 1.641(c)–1Electing small business trust.

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

§ 1.641(c)–1 Electing small business trust.

(a) *In general.* An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. *See* § 1.1361–1(m).

(b) *Definitions*—(1) *Grantor portion.* The grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E.

(2) *S portion.* The S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(3) *Non-S portion.* The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) *Taxation of grantor portion.* The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) *Taxation of S portion*—(1) *In general.* The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) *Section 1366 amounts*—(i) *In general.* The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. *See* § 1.1361–1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) *Special rule for charitable contributions.* If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

(iii) *Multiple S corporations.* If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) *Gains and losses on disposition of S stock*—(i) *In general.* The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) *Installment method.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (g)(3) of this section for the treatment of interest on the installment obligation. See § 1.1361–1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) *Distributions in excess of basis.* Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) *State and local income taxes and administrative expenses*—(i) *In general.* State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (h) are taken into account by the S portion.

(ii) *Special rule for certain interest.* Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) *Tax rates and exemption of S portion*—(1) *Income tax rate.* Except for capital gains, the highest marginal trust rate provided in section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) *Alternative minimum tax exemption.* The exemption amount of the S portion under section 55(d) is zero.

(f) *Adjustments to basis of stock in the S portion under section 1367.* The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) *Taxation of non-S portion*—(1) *In general.* The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code. The non-S portion may consist of more than one share pursuant to section 663(c).

(2) *Dividend income under section 1368(c)(2).* Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) *Interest on installment obligations.* If income from the sale or disposition of stock in an S corporation is reported

by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) *Charitable deduction.* For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(h) *Allocation of state and local income taxes and administration expenses.* Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(i) *Treatment of distributions from the trust.* Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items of income, loss, deduction, or credit taken into account by the grantor portion or the S portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(j) *Termination or revocation of ESBT election.* If the ESBT election of the trust terminates pursuant to § 1.1361–1(m)(5) or the ESBT election is revoked pursuant to § 1.1361–1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(k) *Effective date.* This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (l) *Example 1* of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of ESBTs beginning after December 31, 1996.

(l) *Examples.* The following examples illustrate the rules of this section:

Example 1. Comprehensive example. (i) Trust has a valid ESBT election in effect. Under section 678, *B* is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E. Trust owns stock in *X*, an S corporation, and in *Y*, a C corporation. During 2000, Trust receives a distribution from *X* of $5,100, of which $5,000 is applied against Trust's adjusted basis in the *X* stock in accordance with section 1368(c)(1) and $100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Ordinary income attributable to *X* under section 1366	$5,000
Dividend income from *Y*	$900
Dividend from *X* representing C corporation earnings and profits	$100
Total trust income	$6,000
Charitable contributions attributable to *X* under section 1366	$300
Trustee fees	$200
State and local income taxes	$100

(iii) Trust's items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

B must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:

Ordinary income from *X*	$500
Dividend income from *Y*	$90

Dividend income from *X*	$10
Total grantor portion income	$600

The total income of the S portion is $4,500, determined as follows:

Ordinary income from *X*	$5,000
Less: Grantor portion	($500)
Total S portion income	$4,500

The total income of the non-S portion is $900 determined as follows:

Dividend income from *Y* (less grantor portion)	$810
Dividend income from *X* (less grantor portion)	$90
Total non-S portion income	$900

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the $6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) *B* must take into account the following deductions attributable to the grantor portion of the trust:

Charitable contributions from *X*	$30
Trustee fees	$20
State and local income taxes	$10

(vi) The taxable income of the S portion is $4,005, determined as follows:

Ordinary income from *X*	$4,500
Less: Charitable contributions from *X* (less grantor portion)	($270)
75% of trustee fees	($150)
75% of state and local income taxes	($75)
Taxable income of S portion	$4,005

(vii) The taxable income of the non-S portion is $755, determined as follows:

Dividend income from *Y*	$810
Dividend income from *X*	$90
Total non-S portion income	$900
Less: 15% of trustee fees	($30)
15% state and local income taxes	($15)
Personal exemption	($100)
Taxable income of non-S portion	$755

Example 2. Sale of S stock. Trust has a valid ESBT election in effect and owns stock in *X*, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in *X* to a person who is unrelated to Trust and its beneficiaries and realizes a capital gain of $5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

Example 3. (i) *Sale of S stock for an installment note.* Assume the same facts as in *Example 2,* except that Trust sells its stock in *X* for a $400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock.

(ii) *Loss on installment sale.* Assume Trust's basis in its *X* stock was $500,000. Therefore, Trust sustains a capital loss of $100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).

(iii) *Gain on installment sale.* Assume Trust's basis in its *X* stock was $300,000 and that the $100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the $100,000 gain recognized annually is taken into account by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.

Example 4. Charitable lead annuity trust. Trust is a charitable lead annuity trust which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in *X*, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays $10,000 to a charitable organization described in section 170(c)(2). The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion by distributing S corporation stock, no charitable deduction is available to the S portion.

Example 5. ESBT distributions. (i) As of January 1, 2002, Trust owns stock in *X*, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. *X* elects to be an S corporation effective January 1, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, *X* makes an $8,000 distribution to Trust, of which $3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the *X* stock under section 1368(b). The trustee of Trust makes a distribution of $4,000 to Beneficiary during 2003. For 2003, Trust's share of *X*'s section 1366 items is $5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes.

(ii) For 2003, Trust has $5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has $3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of

$3,000, which represents the amount distributed to Beneficiary during the year ($4,000), not to exceed the amount of DNI ($3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

[T.D. 8994, 67 FR 34395, May 14, 2002]

§ 1.642(a)(1)–1 Partially tax-exempt interest.

An estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit does not relate to interest properly allocable to a beneficiary under section 652 or 662 and the regulations thereunder. A beneficiary of an estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit relates to interest properly allocable to him under section 652 or 662 and the regulations thereunder. If an estate or trust holds partially tax-exempt bonds and elects under section 171 to treat the premium on the bonds as amortizable, the credit allowable under section 35, with respect to the bond interest (whether allowable to the estate or trust or to the beneficiary), is reduced under section 171(a)(3) by reducing the shares of the interest allocable, respectively, to the estate or trust and its beneficiary by the portion of the amortization deduction attributable to the shares.

§ 1.642(a)(2)–1 Foreign taxes.

An estate or trust is allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States to the extent allowed by section 901 only for so much of those taxes as are not properly allocable under that section to the beneficiaries. See section 901(b)(4). For purposes of section 901(b)(4), the term *beneficiaries* includes charitable beneficiaries.

§ 1.642(a)(3)–1 Dividends received by an estate or trust.

An estate or trust is allowed a credit against the tax for dividends received on or before December 31, 1964 (see section 34), only for so much of the dividends as are not properly allocable to any beneficiary under section 652 or 662. Section 642(a)(3), and this section do not apply to amounts received as dividends after December 31, 1964. For treatment of the credit in the hands of the beneficiary see § 1.652(b)–1.

[T.D. 6777, 29 FR 17808, Dec. 16, 1964]

§ 1.642(a)(3)–2 Time of receipt of dividends by beneficiary.

In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. For example, a simple trust, reporting on the basis of a fiscal year ending October 30, receives quarterly dividends on November 3, 1954, and February 3, May 3, and August 3, 1955. These dividends are all allocable to beneficiary A, reporting on a calendar year basis, under section 652 and are deemed received by A in 1955. See section 652(c). Accordingly, A may take all these dividends into account in determining his credit for dividends received under section 34 and his dividends exclusion under section 116. However, solely for purposes of determining whether dividends deemed received by individuals from trusts or estates qualify under the time limitations of section 34(a) or section 116(a), section 642(a)(3) provides that the time of receipt of the dividends by the trust or estate is also considered the time of receipt by the beneficiary. For example, a simple trust reporting on the basis of a fiscal year ending October 30 receives quarterly dividends on December 3, 1953, and March 3, June 3, and September 3, 1954. These dividends are all allocable to beneficiary A, reporting on the calendar year basis, under section 652 and are includible in his income for 1954. However, for purposes of section 34(a) or section 116(a), these dividends are deemed received by A on the same dates that the trust received them. Accordingly, A may take into account in determining the credit under section 34 only those dividends received by the trust on September 3, 1954, since the dividend received credit is not allowed under section 34 for dividends received before August 1, 1954 (or after December 31, 1964). Section 642(a)(3) and this section do not apply to amounts received by an estate or trust as dividends after December 31, 1964. However, the rules in this section relating to time of receipt of dividends by a beneficiary are applicable to dividends received by an estate or trust prior to January 1, 1965, and accordingly, such dividends are deemed to be received by the beneficiary (even though received after December 31, 1964) on the same dates that the estate or trust received them for purposes of determining the credit under section 34 or the exclusion under section 116.

[T.D. 6777, 29 FR 17808, Dec. 16, 1964]

§ 1.642(a)(3)–3 Cross reference.

See § 1.683–2(c) for examples relating to the treatment of dividends received by an estate or trust during a fiscal year beginning in 1953 and ending in 1954.

§ 1.642(b)–1 Deduction for personal exemption.

In lieu of the deduction for personal exemptions provided by section 151:

(a) An estate is allowed a deduction of $600,

(b) A trust which, under its governing instrument, is required to distribute currently all of its income for the taxable year is allowed a deduction of $300, and

(c) All other trusts are allowed a deduction of $100.

A trust which, under its governing instrument, is required to distribute all of its income currently is allowed a deduction of $300, even though it also distributes amounts other than income in the taxable year and even though it may be required to make distributions which would qualify for the charitable contributions deduction under section 642(c) (and therefore does not qualify as a ''simple trust'' under sections 651–652). A trust for the payment of an annuity is allowed a deduction of $300 in a taxable year in which the amount of the annuity required to be paid equals or exceeds all the income of the trust for the taxable year. For the meaning of the term *income required to be distributed currently*, see § 1.651(a)–2.

§ 1.642(c)–0 Effective dates.

The provisions of section 642(c) (other than section 642(c)(5)) and of §§ 1.642 (c)–1 through 1.642(c)–4 apply to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning after December 31, 1969. The provisions of section 642(c)(5) and of §§ 1.642(c)–5 through 1.642(c)–7 apply to transfers in trust made after July 31, 1969. For provisions relating to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning before January 1, 1970, see 26 CFR 1.642(c)–1 through 1.642(c)–4 (Rev. as of Jan. 1, 1971).

[T.D. 7357, 40 FR 23739, June 2, 1975]

§ 1.642(c)–1 Unlimited deduction for amounts paid for a charitable purpose.

(a) *In general.* (1) Any part of the gross income of an estate, or trust which, pursuant to the terms of the governing instrument is paid (or treated under paragraph (b) of this section as paid) during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to such estate or trust in lieu of the limited charitable contributions deduction authorized by section 170(a). In applying this paragraph without reference to paragraph (b) of this section, a deduction shall be allowed for an amount paid during the taxable year in respect of gross income received in a previous taxable year, but only if no deduction was allowed for any previous taxable year to the estate or trust, or in the case of a section 645 election, to a related estate, as defined under § 1.645–1(b), for the amount so paid.

(2) In determining whether an amount is paid for a purpose specified in section 170(c)(2) the provisions of section 170(c)(2)(A) shall not be taken into account. Thus, an amount paid to a corporation, trust, or community chest, fund, or foundation otherwise described in section 170(c)(2) shall be considered paid for a purpose specified in section 170(c) even though the corporation, trust, or community chest, fund, or foundation is not created or organized in the United States, any State, the District of Columbia, or any possession of the United States.

(3) See section 642(c)(6) and § 1.642(c)–4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were a private foundation (as

defined in section 509(a) and the regulations thereunder) and not exempt from taxation under section 501(a).

(b) *Election to treat contributions as paid in preceding taxable year*—(1) *In general.* For purposes of determining the deduction allowed under paragraph (a) of this section, the fiduciary (as defined in section 7701(a)(6)) of an estate or trust may elect under section 642(c)(1) to treat as paid during the taxable year (whether or not such year begins before January 1, 1970) any amount of gross income received during such taxable year or any preceding taxable year which is otherwise deductible under such paragraph and which is paid after the close of such taxable year but on or before the last day of the next succeeding taxable year of the estate or trust. The preceding sentence applies only in the case of payments actually made in a taxable year which is a taxable year beginning after December 31, 1969. No election shall be made, however, in respect of any amount which was deducted for any previous taxable year or which is deducted for the taxable year in which such amount is paid.

(2) *Time for making election.* The election under subparagraph (1) of this paragraph shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year. Such election shall, except as provided in subparagraph (4) of this paragraph, become irrevocable after the last day prescribed for making it. Having made the election for any taxable year, the fiduciary may, within the time prescribed for making it, revoke the election without the consent of the Commissioner.

(3) *Manner of making the election.* The election shall be made by filing with the income tax return (or an amended return) for the taxable year in which the contribution is treated as paid a statement which:

(i) States the name and address of the fiduciary,

(ii) Identifies the estate or trust for which the fiduciary is acting,

(iii) Indicates that the fiduciary is making an election under section 642(c)(1) in respect of contributions treated as paid during such taxable year,

(iv) Gives the name and address of each organization to which any such contribution is paid, and

(v) States the amount of each contribution and date of actual payment or, if applicable, the total amount of contributions paid to each organization during the succeeding taxable year, to be treated as paid in the preceding taxable year.

(4) *Revocation of certain elections with consent.* An application to revoke with the consent of the Commissioner any election made on or before June 8, 1970, must be in writing and must be filed not later than September 2, 1975.

No consent will be granted to revoke an election for any taxable year for which the assessment of a deficiency is prevented by the operation of any law or rule of law. If consent to revoke the election is granted, the fiduciary must attach a copy of the consent to the return (or amended return) for each taxable year affected by the revocation. The application must be addressed to the Commissioner of Internal Revenue, Washington, DC 20224, and must indicate:

(i) The name and address of the fiduciary and the estate or trust for which he was acting,

(ii) The taxable year for which the election was made,

(iii) The office of the district director, or the service center, where the return (or amended return) for the year of election was filed, and

(iv) The reason for revoking the election.

[T.D. 7357, 40 FR 23739, June 2, 1975; 40 FR 24361, June 6, 1975; T.D. 9032, 67 FR 78376, Dec. 24, 2002]

§ 1.642(c)–2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

(a) *Estates.* Any part of the gross income of an estate which pursuant to the terms of the will:

(1) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(2) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit,

shall be allowed as a deduction to the estate in lieu of the limited charitable contributions deduction authorized by section 170(a).

(b) *Certain trusts*—(1) *In general.* Any part of the gross income of a trust to which either subparagraph (3) or (4) of this paragraph applies, that by the terms of the governing instrument:

(i) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(ii) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit,

shall be allowed, subject to the limitation provided in subparagraph (2) of this paragraph, as a deduction to the trust in lieu of the limited charitable contributions deduction authorized by section 170(a). The preceding sentence applied only to a trust which is required by the terms of its governing instrument to set amounts aside. See section 642(c)(6) and § 1.642(c)–4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a).

(2) *Limitation of deduction.* Subparagraph (1) of this paragraph applies only to the gross income earned by a trust with respect to amounts transferred to the trust under a will executed on or before October 9, 1969, and satisfying the requirements of subparagraph (4) of this paragraph or transferred to the trust on or before October 9, 1969. For such purposes, any income, gains, or losses, which are derived at any time from the amounts so transferred to the trust shall also be taken into account in applying subparagraph (1) of this paragraph. If any such amount so transferred to the trust is invested or reinvested at any time, any asset received by the trust upon such investment or reinvestment shall also be treated as an amount which was so transferred to the trust. In the case of a trust to which this paragraph applies which contains (i) amounts transferred pursuant to transfers described in the first sentence of this subparagraph and (ii) amounts transferred pursuant to transfers not so described, subparagraph (1) of this paragraph shall apply only if the amounts described in subdivision (i) of this subparagraph, together with all income, gains, and losses derived therefrom, are separately accounted for from the amounts described in subdivision (ii) of this subparagraph, together with all income, gains, and losses derived therefrom. Such separate accounting shall be carried out consistently with the principles of paragraph (c)(4) of § 53.4947–1 of this chapter (Foundation Excise Tax Regulations), relating to accounting for segregated amounts of split-interest trusts.

(3) *Trusts created on or before October 9, 1969.* A trust to which this subparagraph applies is a trust, testamentary or otherwise, which was created on or before October 9, 1969, and which qualifies under either subdivision (i) or (ii) of this subparagraph.

(i) *Transfer of irrevocable remainder interest to charity.* To qualify under this subdivision the trust must have been created under the terms of an instrument granting an irrevocable remainder interest in such trust to or for the use of an organization described in section 170(c). If the instrument granted a revocable remainder interest but the power to revoke such interest terminated on or before October 9, 1969, without the remainder interest having been revoked, the remainder interest will be treated as irrevocable for purposes of the preceding sentence.

(ii) *Grantor under a mental disability to change terms of trust.* (A) To qualify under this subdivision (ii) the trust must have been created by a grantor who was at all times after October 9, 1969, under a mental disability to change the terms of the trust. The term *mental disability* for this purpose means mental incompetence to change the terms of the trust, whether or not there has been an adjudication of mental incompetence and whether or not there has been an appointment of a committee, guardian, fiduciary, or other person charged with the care of the person or property of the grantor.

(B) If the grantor has not been adjudged mentally incompetent, the trustee must obtain from a qualified physician a certificate stating that the grantor of the trust has been mentally incompetent at all times after October 9, 1969, and that there is no reasonable probability that the grantor's mental capacity will ever improve to the extent that he will be mentally competent to change the terms of the trust. A copy of this certification must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such medical opinion must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. The original certificate must be retained by the trustee of the trust.

(C) If the grantor has been adjudged mentally incompetent, a copy of the judgment or decree, and any modification thereof, must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such judgment or decree must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. A copy of such judgment or decree must also be retained by the trustee of the trust.

(D) This subdivision (ii) applies even though a person charged with the care of the person or property of the grantor has the power to change the terms of the trust.

(4) *Testamentary trust established by will executed on or before October 9, 1969.* A trust to which this subparagraph applies is a trust which was established by will executed on or before October 9, 1969, and which qualifies under either subdivision (i), (ii), or (iii) of this subparagraph. This subparagraph does not apply, however, to that portion of any trust, not established by a will executed on or before October 9, 1969, which was transferred to such trust by a will executed on or before October 9, 1969. Nor does it apply to that portion of any trust, not established by a will executed on or before October 9, 1969, which was subject to a testamentary power of appointment that fails by reason of the testator's nonexercise of the power in a will executed on or before October 9, 1969.

(i) *Testator dying within 3 years without republishing his will.* To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise.

(ii) *Testator having no right to change his will.* To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, and who at no time after that date had the right to change any portion of such will pertaining to such trust. This subdivision could apply, for example, where a contract has been entered into for the execution of wills containing reciprocal provisions as well as provisions for the benefit of an organization described in section 170(c) and under applicable local law the surviving testator is prohibited from revoking his will because he has accepted the benefit of the provisions of the will of the other contracting party.

(iii) *Testator under a mental disability to republish his will.* To qualify under this subdivision the trust must have been established by the will of a testator who died after October 8, 1972, without having amended any dispositive provision of such will after October 9, 1969, and before October 9, 1972, by codicil or otherwise, and who is under a mental disability at all times after October 8, 1972, to amend such will, by codicil or otherwise. The provisions of subparagraph (3)(ii) of this paragraph with respect to mental incompetence apply for purposes of this subdivision.

(iv) *Amendment of dispositive provisions.* The provisions of paragraph (e) (4) and (5) of § 20.2055–2 of this chapter (Estate Tax Regulations) are to be applied under subdivisions (i) and (iii) of this subparagraph in determining whether there has been an amendment of a dispositive provision of a will.

(c) *Pooled income funds.* Any part of the gross income of a pooled income fund to which § 1.642(c)–5 applies for the taxable year that is attributable to net long-term capital gain (as defined in section 1222(7)) which, pursuant to the terms of the governing instrument, is permanently set aside during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to the fund in lieu of the limited charitable contributions deduction authorized by section 170(a). No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if, under the terms of the fund's governing instrument and applicable local law, the trustee has the power, whether or not exercised, to satisfy the income beneficiaries' right to income by the payment of either: an amount equal to a fixed percentage of the fair market value of the fund's assets (whether determined annually or averaged on a multiple year basis); or any amount that takes into account unrealized appreciation in the value of the fund's assets. In addition, no amount of net long-term capital gain shall be considered permanently set aside for charitable purposes to the extent the trustee distributes proceeds from the sale or exchange of the fund's assets as income within the meaning of § 1.642(c)–5(a)(5)(i). No deduction shall be allowed under this paragraph for any portion of the gross income of such fund which is (1) attributable to income other than net long-term capital gain (2) earned with respect to amounts transferred to such fund before August 1, 1969. However, see paragraph (b) of this section for a deduction (subject to the limitations of such paragraph) for amounts permanently set aside by a pooled income fund which meets the requirements of that paragraph. The principles of paragraph (b) or (2) of this section with respect to investment, reinvestment, and separate accounting shall apply under this paragraph in the case of amounts transferred to the fund after July 31, 1969.

(d) *Disallowance of deduction for certain amounts not deemed to be permanently set aside for charitable purposes.* No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible. Thus, for example, where there is possibility of the invasion of the corpus of a charitable remainder trust, as defined in § 1.664–1(a)(1)(ii), in order to make payment of the annuity amount or unitrust amount, no deduction will be allowed under paragraph (a) of this section in respect of any amount set aside by an estate for distribution to such a charitable remainder trust.

(e) *Effective dates.* Generally, the second sentence of paragraph (c) of this section, concerning the loss of any charitable deduction for long-term capital gains if the fund's income may be determined by a fixed percentage of the fair market value of the fund's assets or by any amount that takes into account unrealized appreciation in the value of the fund's assets, applies for taxable years beginning after January 2, 2004. In a state whose statute permits income to be determined by reference to a fixed percentage of, or the unrealized appreciation in, the value of the fund's assets, net long-term capital gain of a pooled income fund may be considered to be permanently set aside for charitable purposes if the fund's governing instrument is amended or reformed to eliminate the possibility of determining income in such a manner and if income has not been determined in this manner. For this purpose, a judicial proceeding to reform the fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.

For treatment of distributions by an estate to a charitable remainder trust, see paragraph (a)(5)(iii) of § 1.664–1.

[T.D. 7357, 40 FR 23740, June 2, 1975; 40 FR 24361, June 6, 1975, as amended by T.D. 9102, 69 FR 17, Jan. 2, 2004]

§ 1.642(c)–3 Adjustments and other special rules for determining unlimited charitable contributions deduction.

(a) *Income in respect of a decedent.* For purposes of §§ 1.642(c)–1 and 1.642(c)–2, an amount received by an estate or trust which is includible in its gross income under section 691(a)(1) as income in respect of a decedent shall be included in the gross income of the estate or trust.

(b) *Reduction of charitable contributions deduction by amounts not included in gross income.* (1) If an estate, pooled income fund, or other trust pays, permanently sets aside, or uses any amount of its income for a purpose specified in section 642(c) (1), (2) or (3) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction allowable under § 1.642(c)–1 or § 1.642(c)–2 is limited to the gross income so paid, permanently set aside, or used. In the case of a pooled income fund for which a deduction is allowable under paragraph (c) of § 1.642(c)–2 for amounts permanently set aside, only the gross income of the fund which is attributable to net long-term capital gain (as defined in section 1222(7)) shall be taken into account.

(2) In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c) (1), (2), or (3) include particular items of income of an estate or trust not included in gross income, the specific provision controls if the governing instrument specifically provides as to the source out of which amounts are to be paid, permanently set aside, or used for such a purpose.

In the absence of specific provisions in the governing instrument, an amount to which section 642(c) (1), (2) or (3) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See paragraph (b) of § 1.643(a)–5 for the method of determining the allocable portion of exempt income and foreign income.

(3) For examples showing the determination of the character of an amount deductible under § 1.642(c)–1 or § 1.642(c)–2, see examples 1 and 2 in § 1.662(b)–2 and paragraph (e) of the example in § 1.662(c)–4.

(4) For the purpose of this paragraph, the provisions of section 116 are not to be taken into account.

(c) *Capital gains included in charitable contribution.* Where any amount of the income paid, permanently set aside, or used for a purpose specified in section 642(c) (1), (2), or (3), is attributable to net long-term capital gain (as defined in section 1222(7)), the amount of the deduction otherwise allowable under § 1.642(c)–1 or § 1.642(c)–2, must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the contribution to which § 1.642(c)–1 or § 1.642(c)–2 applies is deemed to consist of net long-term capital gains, see paragraph (b) of this section. The application of this paragraph may be illustrated by the following examples:

Example 1. Under the terms of the trust instrument, the income of a trust described in § 1.642(c)–2 (b)(3)(i) is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During the taxable year ending December 31, 1970, the trust has long-term capital gains of $100,000 from property transferred to it on or before October 9, 1969, which are permanently set aside for charitable purposes. The trust includes $100,000 in gross income but is allowed a deduction of $50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of $50,000 under section 642(c)(2) ($100,000 permanently set aside for charitable purposes less $50,000 allowed as a deduction under section 1202 with respect to such $100,000).

Example 2. Under the terms of the will, $200,000 of the income (including $100,000 capital gains) for the taxable year 1972 of an estate is distributed, one-quarter to each of two individual beneficiaries and one-half to N University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During 1972 the estate has ordinary income of $200,000, long-term capital gains of $100,000, and no capital losses. It is assumed that for 1972 the estate has no other items of income or any deductions other than those discussed herein. The entire capital gains of $100,000 are included in the gross income of the estate for 1972, and N University receives $100,000 from the estate in such year. However, the amount allowable to the estate under section 642(c)(1) is subject to appropriate adjustment for the deduction allowable under section 1202. In view of the distributions of $25,000 of capital gains to each of the individual beneficiaries, the deduction allowable to the estate under section 1202 is limited by such section to $25,000 [($100,000 capital gains less $50,000 capital gains includible in income of individual beneficiaries under section 662) × 50%]. Since the whole of this $25,000 deduction under section 1202 is attributable to the distribution of $50,000 of capital gains to N University, the deduction allowable to the estate in 1972 under section 642(c)(1) is $75,000 [$100,000 (distributed to N) less $25,000 (proper adjustment for section 1202 deduction)].

Example 3. Under the terms of the trust instrument, 30 percent of the gross income (exclusive of capital gains) of a trust described in § 1.642(c)–2(b)(3)(i) is currently distributed to B, the sole income beneficiary. Net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and undistributed ordinary income are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of B. Upon B's death the remainder of the trust is to be distributed to M Church. During the taxable year 1972, the trust has ordinary income of $100,000, long-term capital gains of $15,000, short-term capital gains of $1,000, long-term capital losses of $5,000, and short-term capital losses of $2,500. It is assumed that the trust has no other items of income or any deductions other than those discussed herein. All the ordinary income and capital gains and losses are attributable to amounts transferred to the trust before October 9, 1969. The trust includes in gross income for 1972 the total amount of $116,000 [$100,000 (ordinary income)+$16,000 (total capital gains determined without regard to capital losses)]. Pursuant to the terms of the governing instrument the trust distributes to B in 1972 the amount of $30,000 ($100,000×30%). The balance of $78,500 [($116,000 less $7,500 capital losses) −030,000 distribution] is available for the set-aside for charitable purposes. In determining taxable income for 1972 the capital losses of $7,500 ($5,000+$2,500) are allowable in full under section 1211(b)(1). The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of $8,500 ($16,000 less $7,500) is the excess of the net long-term capital gain of $10,000 ($15,000 less $5,000) over the net short-term capital loss of $1,500 ($2,500 less $1,000). The deduction under section 1202 is $4,250 ($8,500×50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, for 1972 the deduction allowable to the trust under section 642(c)(2) is $74,250 [$78,500 (set-aside for M) less $4,250 (proper adjustment for section 1202 deduction)].

Example 4. During the taxable year a pooled income fund, as defined in § 1.642(c)–5, has in addition to ordinary income long-term capital gains of $150,000, short-term capital gains of $15,000, long-term capital losses of $100,000, and short-term capital losses of $10,000. Under the Declaration of Trust and pursuant to State law net long-term capital gain is allocable to corpus and net short-term capital gain is to be distributed to the income beneficiaries of the fund. All the capital gains and losses are attributable to amounts transferred to the fund after July 31, 1969. In view of the distribution of the net short-term capital gain of $5,000 ($15,000 less $10,000) to the income beneficiaries, the deduction allowed to the fund under section 1202 is limited by such section to $25,000 [($150,000 (long-term capital gains) less $100,000 (long-term capital losses))×50%]. Since the whole of this deduction under section 1202 is attributable to the set-aside for charitable purposes, the deduction of $50,000 ($150,000 less $100,000) otherwise allowable under section 642(c)(3) is subject to appropriate adjustment under section 642(c)(4) for the deduction allowable under section 1202. Accordingly, the amount of the set-aside deduction is $25,000 [$50,000 (set-aside for public charity) less $25,000 (proper adjustment for section 1202 deduction)].

Example 5. The facts are the same as in example 4 except that under the Declaration of Trust and pursuant to State law all the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year is allocable to corpus of the fund. The fund would thus include in gross income total capital gains of $165,000 ($150,000+$15,000). In determining taxable income for the taxable year the capital losses of $110,000 ($100,000+$10,000) are allowable in full under section 1211(b)(1). The net capital gain of $55,000 ($165,000 less $110,000) is available for the set-aside for charitable purposes under section 642(c)(3) only in the amount of the net long-term capital gain of $50,000 ($150,000 long-term gains less $100,000 long-term losses). The deduction under section

1202 is $25,000 ($50,000×50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, the deduction allowable to the fund under section 642(c)(3) is $25,000 [$50,000 (set-aside for public charity) less $25,000 (proper adjustment for section 1202 deduction)]. The $5,000 balance of net capital gain (capital gain net income for taxable years beginning after December 31, 1976) is taken into account in determining taxable income of the pooled income fund for the taxable year.

(d) *Disallowance of deduction for amounts allocable to unrelated business income.* In the case of a trust, the deduction otherwise allowable under § 1.642(c)–1 or § 1.642(c)–2 is disallowed to the extent of amounts allocable to the trust's unrelated business income. See section 681(a) and the regulations thereunder.

(e) *Disallowance of deduction in certain cases.* For disallowance of certain deductions otherwise allowable under section 642(c) (1), (2), or (3), see sections 508(d) and 4948(c)(4).

(f) *Information returns.* For rules applicable to the annual information return that must be filed by trusts claiming a deduction under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

[T.D. 7357, 40 FR 23741, June 2, 1975; 40 FR 24361, June 6, 1975, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.642(c)–4 Nonexempt private foundations.

In the case of a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a) for the taxable year, a deduction for amounts paid or permanently set aside, or used for a purpose specified in section 642(c) (1), or (2) shall not be allowed under § 1.642(c)–1 or § 1.642(c)–2, but such trust shall, subject to the provisions applicable to individuals, be allowed a deduction under section 170 for charitable contributions paid during the taxable year. Section 642(c)(6) and this section do not apply to a trust described in section 4947(a)(1) unless such trust fails to meet the requirements of section 508(e). However, if on October 9, 1969, or at any time thereafter, a trust is recognized as being exempt from taxation under section 501(a) as an organization described in section 501(c)(3), if at such time such trust is a private foundation, and if at any time thereafter such trust is determined not to be exempt from taxation under section 501(a) as an organization described in section 501(c)(3), section 642(c)(6) and this section will apply to such trust. See § 1.509 (b)–1 (b).

[T.D. 7357, 40 FR 23742, June 2, 1975; 40 FR 24362, June 6, 1975]

§ 1.642(c)–5 Definition of pooled income fund.

(a) *In general*—(1) *Application of provisions.* Section 642(c)(5) prescribes certain rules for the valuation of contributions involving transfers to certain funds described in that section as pooled income funds. This section sets forth the requirements for qualifying as a pooled income fund and provides for the manner of allocating the income of the fund to the beneficiaries. Section 1.642(c)–6 provides for the valuation of a remainder interest in property transferred to a pooled income fund. Section 1.642(c)–7 provides transitional rules under which certain funds may be amended so as to qualify as pooled income funds in respect to transfers of property occurring after July 31, 1969.

(2) *Tax status of fund and its beneficiaries.* Notwithstanding any other provision of this chapter, a fund which meets the requirements of a pooled income fund, as defined in section 642(c)(5) and paragraph (b) of this section, shall not be treated as an association within the meaning of section 7701(a)(3). Such a fund, which need not be a trust under local law, and its beneficiaries shall be taxable under part I, subchapter J, chapter 1 of the Code, but the provisions of subpart E (relating to grantors and others treated as substantial owners) of such part shall not apply to such fund.

(3) *Recognition of gain or loss on transfer to fund.* No gain or loss shall be recognized to the donor on the transfer of property to a pooled income fund. In such case, the fund's basis and holding period with respect to property transferred to the fund by a donor shall be determined as provided in sections 1015(b) and 1223(2). If, however, a donor

transfers property to a pooled income fund and, in addition to creating or retaining a life income interest therein, receives property from the fund, or transfers property to the fund which is subject to an indebtedness, this subparagraph shall not apply to the gain realized by reason of (i) the receipt of such property or (ii) the amount of such indebtedness, whether or not assumed by the pooled income fund, which is required to be treated as an amount realized on the transfer. For applicability of the bargain sale rules, see section 1011(b) and the regulations thereunder.

(4) *Charitable contributions deduction.* A charitable contributions deduction for the value of the remainder interest, as determined under § 1.642(c)–6, may be allowed under section 170, 2055, 2106, or 2522, where there is a transfer of property to a pooled income fund. For a special rule relating to the reduction of the amount of a charitable contribution of certain ordinary income property or capital gain property, see section 170(e)(1) (A) or (B)(i) and the regulations thereunder.

(5) *Definitions.* For purposes of this section, §§ 1.642(c)–6 and 1.642(c)–7:

(i) The term *income* has the same meaning as it does under section 643(b) and the regulations thereunder, except that income generally may not include any long-term capital gains. However, in conformance with the applicable state statute, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee's power to adjust between income and principal to fulfill the trustee's duty of impartiality, if the state statute both provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)–1. In exercising a power to adjust, the trustee must allocate to principal, not to income, the proceeds from the sale or exchange of any assets contributed to the fund by any donor or purchased by the fund at least to the extent of the fair market value of those assets on the date of their contribution to the fund or of the purchase price of those assets purchased by the fund. This definition of income applies for taxable years beginning after January 2, 2004.

(ii) The term *donor* includes a decedent who makes a testamentary transfer of property to a pooled income fund.

(iii) The term *governing instrument* means either the governing plan under which the pooled income fund is established and administered or the instrument of transfer, as the context requires.

(iv) The term *public charity* means an organization described in clause (i) to (vi) of section 170(b)(1)(A). If an organization is described in clause (i) to (vi) of section 170(b)(1)(A) and is also described in clause (viii) of such section, it shall be treated as a public charity.

(v) The term *fair market value,* when used with respect to property, means its value in excess of the indebtedness or charges against such property.

(vi) The term *determination date* means each day within the taxable year of a pooled income fund on which a valuation is made of the property in the fund. The property in the fund shall be valued on the first day of the taxable year of the fund and on at least 3 other days within the taxable year. The period between any two consecutive determination dates within the taxable year shall not be greater than 3 calendar months. In the case of a taxable year of less than 12 months, the property in the fund shall be valued on the first day of such taxable year and on such other days within such year as occur at successive intervals of no greater than 3 calendar months. Where a valuation date falls on a Saturday, Sunday, or legal holiday (as defined in section 7503 and the regulations thereunder), the valuation may be made on either the next preceding day which is not a Saturday, Sunday, or legal holiday or the next succeeding day which is not a Saturday, Sunday, or legal holiday, so long as the next such preceding day or next such succeeding day is consistently used where the valuation date falls on a Saturday, Sunday, or legal holiday.

(6) *Cross references.* (i) See section 4947(a)(2) and section 4947(b)(3)(B) for the application to pooled income funds of the provisions relating to private foundations and section 508(e) for rules relating to provisions required in the

governing instrument prohibiting certain activities specified in section 4947(a)(2).

(ii) For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

(b) *Requirements for qualification as a pooled income fund.* A pooled income fund to which this section applies must satisfy all of the following requirements:

(1) *Contribution of remainder interest to charity.* Each donor must transfer property to the fund and contribute an irrevocable remainder interest in such property to or for the use of a public charity, retaining for himself, or creating for another beneficiary or beneficiaries, a life income interest in the transferred property. A contingent remainder interest shall not be treated as an irrevocable remainder interest for purposes of this subparagraph.

(2) *Creation of life income interest.* Each donor must retain for himself for life an income interest in the property transferred to such fund, or create an income interest in such property for the life of one or more beneficiaries, each of whom must be living at the time of the transfer of the property to the fund by the donor. The term *one or more beneficiaries* includes those members of a named class who are alive and can be ascertained at the time of the transfer of the property to the fund. In the event more than one beneficiary of the income interest is designated, such beneficiaries may enjoy their shares of income concurrently, consecutively, or both concurrently and consecutively. The donor may retain the power exercisable only by will to revoke or terminate the income interest of any designated beneficiary other than the public charity. The governing instrument must specify at the time of the transfer the particular beneficiary or beneficiaries to whom the income is payable and the share of income distributable to each person so specified. The public charity to or for the use of which the remainder interest is contributed may also be designated as one of the beneficiaries of an income interest. The donor need not retain or create a life interest in all the income from the property transferred to the fund provided any income not payable under the terms of the governing instrument to an income beneficiary is contributed to, and within the taxable year in which it is received is paid to, the same public charity to or for the use of which the remainder interest is contributed. No charitable contributions deduction shall be allowed to the donor for the value of such income interest of the public charity or for the amount of any such income paid to such organization.

(3) *Commingling of property required.* The property transferred to the fund by each donor must be commingled with, and invested or reinvested with, other property transferred to the fund by other donors satisfying the requirements of subparagraphs (1) and (2) of this paragraph. The governing instrument of the pooled income fund must contain a provision requiring compliance with the preceding sentence. The public charity to or for the use of which the remainder interest is contributed may maintain more than one pooled income fund, provided that each such fund is maintained by the organization and is not a device to permit a group of donors to create a fund which may be subject to their manipulation. The fund must not include property transferred under arrangements other than those specified in section 642(c)(5) and this paragraph. However, a fund shall not be disqualified as a pooled income fund under this paragraph because any portion of its properties is invested or reinvested jointly with other properties, not a part of the pooled income fund, which are held by, or for the use of, the public charity which maintains the fund, as for example, with securities in the general endowment fund of the public charity to or for the use of which the remainder interest is contributed. Where such joint investment or reinvestment of properties occurs, records must be maintained which sufficiently identify the portion of the total fund which is owned by the pooled income fund and the income earned by, and attributable to, such portion. Such a joint investment or reinvestment of properties shall not be treated as an association or partnership for purposes of the Code.

A bank which serves as trustee of more than one pooled income fund may maintain a common trust fund to which section 584 applies for the collective investment and reinvestment of moneys of such funds.

(4) *Prohibition against exempt securities.* The property transferred to the fund by any donor must not include any securities, the income from which is exempt from tax under subtitle A of the Code, and the fund must not invest in such securities. The governing instrument of the fund must contain specific prohibitions against accepting or investing in such securities.

(5) *Maintenance by charitable organization required.* The fund must be maintained by the same public charity to or for the use of which the irrevocable remainder interest is contributed. The requirement of maintenance will be satisfied where the public charity exercises control directly or indirectly over the fund. For example, this requirement of control shall ordinarily be met when the public charity has the power to remove the trustee or trustees of the fund and designate a new trustee or trustees. A national organization which carries out its purposes through local organizations, chapters, or auxiliary bodies with which it has an identity of aims and purposes may maintain a pooled income fund (otherwise satisfying the requirements of this paragraph) in which one or more local organizations, chapters, or auxiliary bodies which are public charities have been named as recipients of the remainder interests. For example, a national church body may maintain a pooled income fund where donors have transferred property to such fund and contributed an irrevocable remainder interest therein to or for the use of various local churches or educational institutions of such body. The fact that such local organizations or chapters have been separately incorporated from the national organization is immaterial.

(6) *Prohibition against donor or beneficiary serving as trustee.* The fund must not have, and the governing instrument must prohibit the fund from having, as a trustee a donor to the fund or a beneficiary (other than the public charity to or for the use of which the remainder interest is contributed) of an income interest in any property transferred to such fund. Thus, if a donor or beneficiary (other than such public charity) directly or indirectly has general responsibilities with respect to the fund which are ordinarily exercised by a trustee, such fund does not meet the requirements of section 642(c)(5) and this paragraph. The fact that a donor of property to the fund, or a beneficiary of the fund, is a trustee, officer, director, or other official of the public charity to or for the use of which the remainder interest is contributed ordinarily will not prevent the fund from meeting the requirements of section 642(c)(5) and this paragraph.

(7) *Income of beneficiary to be based on rate of return of fund.* Each beneficiary entitled to income of any taxable year of the fund must receive such income in an amount determined by the rate of return earned by the fund for such taxable year with respect to his income interest, computed as provided in paragraph (c) of this section. The governing instrument of the fund shall direct the trustee to distribute income currently or within the first 65 days following the close of the taxable year in which the income is earned. Any such payment made after the close of the taxable year shall be treated as paid on the last day of the taxable year. A statement shall be attached to the return of the pooled income fund indicating the date and amount of such payments after the close of the taxable year. Subject to the provisions of part I, subchapter J, chapter 1 of the Code, the beneficiary shall include in his gross income all amounts properly paid, credited, or required to be distributed to the beneficiary during the taxable year or years of the fund ending within or with his taxable year. The governing instrument shall provide that the income interest of any designated beneficiary shall either terminate with the last regular payment which was made before the death of the beneficiary or be prorated to the date of his death.

(8) *Termination of life income interest.* Upon the termination of the income interest retained or created by any donor, the trustee shall sever from the fund an amount equal to the value of the remainder interest in the property

upon which the income interest is based. The value of the remainder interest for such purpose may be either (i) its value as of the determination date next succeeding the termination of the income interest or (ii) its value as of the date on which the last regular payment was made before the death of the beneficiary if the income interest is terminated on such payment date. The amount so severed from the fund must either be paid to, or retained for the use of, the designated public charity, as provided in the governing instrument. However, see subparagraph (3) of this paragraph for rules relating to commingling of property.

(c) *Allocation of income to beneficiary*—(1) *In general.* Every income interest retained or created in property transferred to a pooled income fund shall be assigned a proportionate share of the annual income earned by the fund, such share, or unit of participation, being based on the fair market value of such property on the date of transfer, as provided in this paragraph.

(2) *Units of participation*—(i) *Unit plan. (a)* On each transfer of property by a donor to a pooled income fund, one or more units of participation in the fund shall be assigned to the beneficiary or beneficiaries of the income interest retained or created in such property, the number of units of participation being equal to the number obtained by dividing the fair market value of the property by the fair market value of a unit in the fund at the time of the transfer.

(b) The fair market value of a unit in the fund at the time of the transfer shall be determined by dividing the fair market value of all property in the fund at such time by the number of units then in the fund. The initial fair market value of a unit in a pooled income fund shall be the fair market value of the property transferred to the fund divided by the number of units assigned to the income interest in that property. The value of each unit of participation will fluctuate with each new transfer of property to the fund in relation to the appreciation or depreciation in the fair market value of the property in the fund, but all units in the fund will always have equal value.

(c) The share of income allocated to to each unit of participation shall be determined by dividing the income of the fund for the taxable year by the outstanding number of units in the fund at the end of such year, except that, consistently with paragraph (b)(7) of this section, income shall be allocated to units outstanding during only part of such year by taking into consideration the period of time such units are outstanding. For this purpose the actual income of such part of the taxable year, or a prorated portion of the annual income, may be used, after making such adjustments as are reasonably necessary to reflect fluctuations during the year in the fair market value of the property in the fund.

(ii) *Other plans.* The governing instrument of the fund may provide any other reasonable method not described in subdivision (i) of this subparagraph for assigning units of participation in the fund and allocating income to such units which reaches a result reasonably consistent with the provisions of such subdivision.

(iii) *Transfers between determination dates.* For purposes of subdivisions (i) and (ii) of this subparagraph, if a transfer of property to the fund by a donor occurs on other than a determination date, the number of units of participation assigned to the income interest in such property may be determined by using the fair market value of the property in the fund on the determination date immediately preceding the date of transfer (determined without regard to the property so transferred), subject, however, to appropriate adjustments on the next succeeding determination date. Such adjustments may be made by any reasonable method, including the use of a method whereby the fair market value of the property in the fund at the time of the transfer is deemed to be the average of the fair market values of the property in the fund on the determination dates immediately preceding and succeeding the date of transfer. For purposes of determining such average any property transferred to the fund between such preceding and succeeding dates, or on such succeeding date, shall be excluded. The application of this subdivision may be illustrated by the following example:

Example. The determination dates of a pooled income fund are the first day of each calendar month. On April 1, 1971, the fair market value of the property in the fund is $100,000, at which time 1,000 units of participation are outstanding with a value of $100 each. On April 15, 1971, B transfers property with a fair market value of $50,000 to the fund, retaining for himself for life an income interest in such property. No other property is transferred to the fund after April 1, 1971. On May 1, 1971, the fair market value of the property in the fund, including the property transferred by B, is $160,000. The average of the fair market values of the property in the fund (excluding the property transferred by B) on April 1 and May 1, 1971, is $105,000 ($100,000+ [$160,000−$50,000]÷2). Accordingly, the fair market value of a unit of participation in the fund on April 15, 1971, at the time of B's transfer may be deemed to be $105 ($105,000/1,000 units), and B is assigned 476.19 units of participation in the fund ($50,000/ $105).

(3) *Special rule for partial allocation of income to charity.* Notwithstanding subparagraph (2) of this paragraph, the governing instrument may provide that a unit of participation is entitled to share in the income of the fund in a lesser amount than would otherwise be determined under such subparagraph, provided that the income otherwise allocable to the unit under such subparagraph is paid within the taxable year in which it is received to the public charity to or for the use of which the remainder interest is contributed under the governing instrument.

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

Example 1. On July 1, 1970, A and B transfer separate properties with a fair market value of $20,000 and $10,000, respectively, to a newly created pooled income fund which is maintained by Y University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves for life an income interest in such property, the remainder interest being contributed to Y University. The pooled income fund assigns an initial value of $100 to each unit of participation in the fund, and under the governing instruments A receives 200 units, and B receives 100 units, in the fund. On October 1, 1970, which is a determination date, C transfers property to the fund with a fair market value of $12,000, retaining in himself for life an income interest in such property and contributing the remainder interest to Y University. The fair market value of the property in the fund at the time of C's transfer is $36,000. The fair market value of A's and B's units at the time of such transfer is $120 each ($36,000/300). By reason of his transfer of property C is assigned 100 units of participation in the fund ($12,000/$120).

Example 2. Assume that the pooled income fund in example 1 earns $2,600 for its taxable year ending June 30, 1971, and there are no further contributions of property to the fund in such year. Further assume $300 is earned in the first quarter ending September 30, 1970. Therefore, the fund earns $1 per unit for the first quarter ($300 divided by 300 units outstanding) and $5.75 per unit for the remainder of the taxable year ([$2,600−$300] divided by 400 units outstanding). If the fund distributes its income for the year based on its actual earnings per quarter, the income must be distributed as follows:

Beneficiary	*Share of income*
A	$1,350 ([200×$1]+[200×$5.75]).
B	$675 ([100×$1]+[100×$5.75]).
C	$575 (100×$5.75).

Example 3. (a) On July 1, 1970, A and B transfer separate properties with a fair market value of $10,000 and $20,000, respectively, to a newly created pooled income fund which is maintained by X University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves an income interest for life in such property, the remainder interest being contributed to X University. The governing instrument provides that each unit of participation in the fund shall have a value of not more than its initial fair market value; the instrument also provides that the income allocable to appreciation in the fair market value of such unit (to the extent in excess of its initial fair market value) at the end of each quarter of the fiscal year is to be distributed currently to X University. On October 1, 1970, which is a determination date, C contributes to the fund property with a fair market value of $60,000 and retains in himself an income interest for life in such property, the remainder interest being contributed to X University. The initial fair market value of the units assigned to A, B, and C is $100. A, B, and C's units of participation are as follows:

Beneficiary	*Units of participation*
A	100 ($10,000 divided by $100).
B	200 ($20,000 divided by $100).
C	100 ($10,000 divided by $100).

(b) The fair market value of the property in the fund at the time of C's contribution is $40,000. Assuming the fair market value of the property in the fund is $100,000 on December 31, 1970, and that the income of the fund for the second quarter ending December 31, 1970, is $2,000, the income is shared by the income beneficiaries and X University as follows:

Beneficiary	Allocation of income
A, B, and C	90% ($90,000 divided by $100,000).
X University	10% ($10,000 divided by $100,000).

(c) For the quarter ending December 31, 1970, each unit of participation is allocated $2 (90 percent×$2,000 divided by 900) of the income earned for that quarter. A, B, C, and X University share in the income as follows:

Beneficiary	Share of income
A	$200 (100×$2).
B	$400 (200×$2).
C	$1,200 (600×$2).
X University	$200 (10%×$2,000).

[T.D. 7105, 36 FR 6477, Apr. 6, 1971; 36 FR 7004, Apr. 13, 1971, as amended by T.D. 7125, 36 FR 11032, June 8, 1971; T.D. 7357, 40 FR 23742, June 2, 1975; T.D. 7633, 44 FR 57925, Oct. 9, 1979; T.D. 9102, 69 FR 18, Jan. 2, 2004]

§ 1.642(c)–6 Valuation of a remainder interest in property transferred to a pooled income fund.

(a) *In general.* (1) For purposes of sections 170, 2055, 2106, and 2522, the fair market value of a remainder interest in property transferred to a pooled income fund is its present value determined under paragraph (d) of this section.

(2) The present value of a remainder interest at the time of the transfer of property to the pooled income fund is determined by computing the present value (at the time of the transfer) of the life income interest and subtracting that value from the fair market value of the transferred property on the valuation date. The fact that the income beneficiary may not receive the last income payment, as provided in paragraph (b)(7) of § 1.642(c)–5, is not taken into account for purposes of determining the value of the life income interest. For purposes of this section, the valuation date is the date on which property is transferred to the fund by the donor except that, for purposes of section 2055 or 2106, it is the alternate valuation date, if elected, under the provisions and limitations set forth in section 2032 and the regulations thereunder.

(3) Any claim for a deduction on any return for the value of the remainder interest in property transferred to a pooled income fund must be supported by a statement attached to the return showing the computation of the present value of the interest.

(b) *Actuarial computations by the Internal Revenue Service.* The regulations in this and in related sections provide tables of actuarial factors and examples that illustrate the use of the tables in determining the value of remainder interests in property. Section 1.7520–1(c)(2) refers to government publications that provide additional tables of factors and examples of computations for more complex situations. If the computation requires the use of a factor that is not provided in this section, the Commissioner may supply the factor upon a request for a ruling. A request for a ruling must be accompanied by a recitation of the facts including the pooled income fund's highest yearly rate of return for the 3 taxable years immediately preceding the date of transfer, the date of birth of each measuring life, and copies of the relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see §§ 601.201 and 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee. If the Commissioner furnishes the factor, a copy of the letter supplying the factor should be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in this section.

(c) *Computation of pooled income fund's yearly rate of return.* (1) For purposes of determining the present value of the life income interest, the yearly rate of return earned by a pooled income fund for a taxable year is the percentage obtained by dividing the amount of income earned by the pooled income fund for the taxable year by an amount equal to—

(i) The average fair market value of the property in such fund for that taxable year; less

(ii) The corrective term adjustment.

(2) The average fair market value of the property in a pooled income fund for a taxable year shall be the sum of the amounts of the fair market value of all property held by the pooled income fund on each determination date, as defined in paragraph (a)(5)(vi) of

§ 1.642(c)–5, of such taxable year divided by the number of determination dates in such taxable year. For such purposes the fair market value of property held by the fund shall be determined without including any income earned by the fund.

(3)(i) The corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within its taxable year by the percentage set forth in column (2) of the following table opposite the period within such year, set forth in column (1), which includes the date on which that payment is made:

TABLE

(1) *Payment period*	(2) *Percentage of payment*
Last week of 4th quarter	0
Balance of 4th quarter	25
Last week of 3d quarter	25
Balance of 3d quarter	50
Last week of 2d quarter	50
Balance of 2d quarter	75
Last week of 1st quarter	75
Balance of 1st quarter	100

(ii) If the taxable year of the fund consists of less than 12 months, the corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within such taxable year by the percentage obtained by subtracting from 1 a fraction the numerator of which is the number of days from the first day of such taxable year to the date of such income payment and the denominator of which is 365.

(4) A pooled income fund's method of calculating its yearly rate of return must be supported by a full statement attached to the income tax return of the pooled income fund for each taxable year.

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

Example 1. (a) The pooled income fund maintained by W University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned $5,000 of income during 1971. The fair market value of its property (determined without including any income earned by the fund), and the income paid out, on the first day of each calendar quarter in 1971 are as follows:

Date	Fair market value of property	Income payment
Jan. 1 ..	$100,000	$1,200
Apr. 1 ...	105,000	1,200
July 1 ...	95,000	1,200
Oct. 1 ...	100,000	1,400
	400,000	5,000

(b) The average fair market value of the property in the fund for 1971 is $100,000 ($400,000, divided by 4).

(c) The corrective term adjustment for 1971 is $3,050, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

Multiplication:	*Product*
100%×$1,200	$1,200
75%×$1,200	900
50%×$1,200	600
25%×$1,400	350
Sum of products	3,050

(d) The pooled income fund's yearly rate of return for 1971 is 5.157 percent, determined as follows:

$5,000÷$100,000 − $3,050=0.05157

Example 2. (a) The pooled income fund maintained by X University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned $5,000 of income during 1971 and paid out $3,000 on December 15, 1971, and $2,000 on January 15, 1972, the last amount being treated under paragraph (b)(7) of § 1.642(c)–5 as paid on December 31, 1971. The fair market value of its property (determined without including any income earned by the fund) on the determination dates in 1971 and the income paid out during 1971 are as follows:

Date	Fair market value of property	Income payment
Jan. 1 ..	$125,000	....
Apr. 1 ...	125,000	....
July 1 ...	75,000	....
Oct. 1 ...	75,000	
Dec. 15	....	$3,000
Dec. 31	....	2,000
	400,000	5,000

(b) The average fair market value of the property in the fund for 1971 is $100,000 ($400,000 divided by 4).

(c) The corrective term adjustment for 1971 is $750, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

	Product
Multiplication:	
0%×$2,000	
25%×$3,000	$750
Sum of products	750

(d) The pooled income fund's yearly rate of return for 1971 is 5.038 percent, determined as follows:

$5,000÷$100,000−$750=0.05038

(d) *Valuation.* The present value of the remainder interest in property transferred to a pooled income fund after April 30, 1999, is determined under paragraph (e) of this section. The present value of the remainder interest in property transferred to a pooled income fund for which the valuation date is before May 1, 1999, is determined under the following sections:

Valuation Dates		Applicable regulations
After	Before	
	01–01–52	1.642(c)–6A(a)
12–31–51	01–01–71	1.642(c)–6A(b)
12–31–70	12–01–83	1.642(c)–6A(c)
11–30–83	05–01–89	1.642(c)–6A(d)
04–30–89	05–01–99	1.642(c)–6A(e)

(e) *Present value of the remainder interest in the case of transfers to pooled income funds for which the valuation date is after April 30, 1999*—(1) *In general.* In the case of transfers to pooled income funds for which the valuation date is after April 30, 1999, the present value of a remainder interest is determined under this section. See, however, § 1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by the use of Table S in paragraph (e)(6) of this section. For purposes of the computations under this section, the age of an individual is the age at the individual's nearest birthday.

(2) *Transitional rules for valuation of transfers to pooled income funds.* (i) For purposes of sections 2055, 2106, or 2624, if on May 1, 1999, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after April 30, 1999, without having regained competency to dispose of the decedent's property, or the decedent died within 90 days of the date that the decedent first regained competency after April 30, 1999, the present value of a remainder interest is determined as if the valuation date with respect to the decedent's gross estate is either before May 1, 1999, or after April 30, 1999, at the option of the decedent's executor.

(ii) For purposes of sections 170, 2055, 2106, 2522, or 2624, in the case of transfers to a pooled income fund for which the valuation date is after April 30, 1999, and before July 1, 1999, the present value of the remainder interest under this section is determined by use of the section 7520 interest rate for the month in which the valuation date occurs (see §§ 1.7520–1(b) and 1.7520–2(a)(2)) and the appropriate actuarial tables under either paragraph (e)(6) of this section or § 1.642(c)–6A(e)(5), at the option of the donor or the decedent's executor, as the case may be.

(iii) For purposes of paragraphs (e)(2)(i) and (ii) of this section, where the donor or decedent's executor is given the option to use the appropriate actuarial tables under either paragraph (e)(6) of this section or § 1.642(c)–6A(e)(5), the donor or decedent's executor must use the same actuarial table with respect to each individual transaction and with respect to all transfers occurring on the valuation date (for example, gift and income tax charitable deductions with respect to the same transfer must be determined based on the same tables, and all assets includible in the gross estate and/or estate tax deductions claimed must be valued based on the same tables).

(3) *Present value of a remainder interest.* The present value of a remainder interest in property transferred to a pooled income fund is computed on the basis of—

(i) Life contingencies determined from the values of *lx* that are set forth in Table 90CM in § 20.2031–7(d)(7) of this chapter (see § 20.2031–7A of this chapter for certain prior periods); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. For purposes of this paragraph (e), the yearly rate of return of a pooled income fund is determined as provided in paragraph (c) of this section unless the highest rate of return is deemed to be the rate described in paragraph (e)(4) of this section for funds in existence less than 3 taxable years. For purposes of this paragraph (e)(3)(ii), the first taxable year of a pooled income fund is considered a taxable year even though the taxable year consists of less than 12 months. However, appropriate adjustments must be made to annualize the rate of return earned by the fund for that period. Where it appears from the facts and circumstances that the highest yearly rate of return of the fund for the 3 taxable years immediately preceding the taxable year in which the transfer of property is made has been purposely manipulated to be substantially less than the rate of return that would otherwise be reasonably anticipated with the purpose of obtaining an excessive charitable deduction, that rate of return may not be used. In that case, the highest yearly rate of return of the fund is determined by treating the fund as a pooled income fund that has been in existence for less than 3 preceding taxable years.

(4) *Pooled income funds in existence less than 3 taxable years.* If a pooled income fund has been in existence less than 3 taxable years immediately preceding the taxable year in which the transfer is made to the fund and the transfer to the fund is made after April 30, 1989, the highest rate of return is deemed to be the interest rate (rounded to the nearest two-tenths of one percent) that is 1 percent less than the highest annual average of the monthly section 7520 rates for the 3 calendar years immediately preceding the calendar year in which the transfer to the pooled income fund is made. The deemed rate of return for transfers to new pooled income funds is recomputed each calendar year using the monthly section 7520 rates for the 3-year period immediately preceding the calendar year in which each transfer to the fund is made until the fund has been in existence for 3 taxable years and can compute its highest rate of return for the 3 taxable years immediately preceding the taxable year in which the transfer of property to the fund is made in accordance with the rules set forth in the first sentence of paragraph (e)(3)(ii) of this section.

(5) *Computation of value of remainder interest.* The factor that is used in determining the present value of a remainder interest that is dependent on the termination of the life of one individual is the factor from Table S in paragraph (e)(6) of this section under the appropriate yearly rate of return opposite the number that corresponds to the age of the individual upon whose life the value of the remainder interest is based (see § 1.642(c)–6A for certain prior periods). The tables in paragraph (e)(6) of this section include factors for yearly rates of return from 4.2 to 14 percent. Many actuarial factors not contained in the tables in paragraph (e)(6) of this section are contained in Table S in Internal Revenue Service Publication 1457, ''Actuarial Values, Book Aleph,'' (7–1999). A copy of this publication is available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. For other situations, see paragraph (b) of this section. If the yearly rate of return is a percentage that is between the yearly rates of return for which factors are provided, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the fair market value of the property on the valuation date by the appropriate remainder factor. This paragraph (e)(5) may be illustrated by the following example:

Example. A, who is 54 years and 8 months, transfers $100,000 to a pooled income fund, and retains a life income interest in the property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 9.47 percent. In Table S, the remainder factor opposite 55 years under 9.4 percent is .17449 and under 9.6 percent is .17001. The present value of the remainder interest is $17,292.00, computed as follows:

Factor at 9.4 percent for age 55	.17449
Factor at 9.6 percent for age 55	.17001
Difference	.00448

Interpolation adjustment:

$$\frac{9.47\% - 9.4\%}{0.2\%} = \frac{x}{.00448}$$

$$x = .00157$$

Factor at 9.4 percent for age 55	.17449
Less: Interpolation adjustment	.00157
Interpolated factor	.17292

Present value of remainder interest:

($100,000×.17292) $17,292.00

(6) *Actuarial tables.* In the case of transfers for which the valuation date is after April 30, 1999, the present value of a remainder interest dependent on the termination of one life in the case of a transfer to a pooled income fund is determined by use of the following Table S:

TABLE S—BASED ON LIFE TABLE 90CM SINGLE LIFE REMAINDER FACTORS APPLICABLE AFTER APRIL 30, 1999

[Interest rate]

Age	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
0	.06752	.06130	.05586	.05109	.04691	.04322	.03998	.03711	.03458	.03233
1	.06137	.05495	.04932	.04438	.04003	.03620	.03283	.02985	.02721	.02487
2	.06325	.05667	.05088	.04580	.04132	.03737	.03388	.03079	.02806	.02563
3	.06545	.05869	.05275	.04752	.04291	.03883	.03523	.03203	.02920	.02668
4	.06784	.06092	.05482	.04944	.04469	.04048	.03676	.03346	.03052	.02791
5	.07040	.06331	.05705	.05152	.04662	.04229	.03845	.03503	.03199	.02928
6	.07310	.06583	.05941	.05372	.04869	.04422	.04025	.03672	.03357	.03076
7	.07594	.06849	.06191	.05607	.05089	.04628	.04219	.03854	.03528	.03236
8	.07891	.07129	.06453	.05853	.05321	.04846	.04424	.04046	.03709	.03407
9	.08203	.07423	.06731	.06115	.05567	.05079	.04643	.04253	.03904	.03592
10	.08532	.07734	.07024	.06392	.05829	.05326	.04877	.04474	.04114	.03790
11	.08875	.08059	.07331	.06683	.06104	.05587	.05124	.04709	.04336	.04002
12	.09233	.08398	.07653	.06989	.06394	.05862	.05385	.04957	.04572	.04226
13	.09601	.08748	.07985	.07304	.06693	.06146	.05655	.05214	.04816	.04458
14	.09974	.09102	.08322	.07624	.06997	.06435	.05929	.05474	.05064	.04694
15	.10350	.09460	.08661	.07946	.07303	.06725	.06204	.05735	.05312	.04930
16	.10728	.09818	.09001	.08268	.07608	.07014	.06479	.05996	.05559	.05164
17	.11108	.10179	.09344	.08592	.07916	.07306	.06755	.06257	.05807	.05399
18	.11494	.10545	.09691	.08921	.08227	.07601	.07034	.06521	.06057	.05636
19	.11889	.10921	.10047	.09259	.08548	.07904	.07322	.06794	.06315	.05880
20	.12298	.11310	.10417	.09610	.08881	.08220	.07622	.07078	.06584	.06135
21	.12722	.11713	.10801	.09976	.09228	.08550	.07935	.07375	.06866	.06403
22	.13159	.12130	.11199	.10354	.09588	.08893	.08260	.07685	.07160	.06682
23	.13613	.12563	.11612	.10748	.09964	.09250	.08601	.08009	.07468	.06975
24	.14084	.13014	.12043	.11160	.10357	.09625	.08958	.08349	.07793	.07284
25	.14574	.13484	.12493	.11591	.10768	.10018	.09334	.08708	.08135	.07611
26	.15084	.13974	.12963	.12041	.11199	.10431	.09728	.09085	.08496	.07956
27	.15615	.14485	.13454	.12513	.11652	.10865	.10144	.09484	.08878	.08322
28	.16166	.15016	.13965	.13004	.12124	.11319	.10580	.09901	.09279	.08706
29	.16737	.15567	.14497	.13516	.12617	.11792	.11035	.10339	.09699	.09109
30	.17328	.16138	.15048	.14047	.13129	.12286	.11510	.10796	.10138	.09532
31	.17938	.16728	.15618	.14599	.13661	.12799	.12004	.11272	.10597	.09974
32	.18568	.17339	.16210	.15171	.14214	.13333	.12520	.11769	.11076	.10435
33	.19220	.17972	.16824	.15766	.14790	.13889	.13058	.12289	.11578	.10920
34	.19894	.18627	.17460	.16383	.15388	.14468	.13618	.12831	.12102	.11426
35	.20592	.19307	.18121	.17025	.16011	.15073	.14204	.13399	.12652	.11958
36	.21312	.20010	.18805	.17691	.16658	.15701	.14814	.13990	.13225	.12514
37	.22057	.20737	.19514	.18382	.17331	.16356	.15450	.14608	.13825	.13096
38	.22827	.21490	.20251	.19100	.18031	.17038	.16113	.15253	.14452	.13705
39	.23623	.22270	.21013	.19845	.18759	.17747	.16805	.15927	.15108	.14344
40	.24446	.23078	.21805	.20620	.19516	.18487	.17527	.16631	.15795	.15013
41	.25298	.23915	.22626	.21425	.20305	.19259	.18282	.17368	.16514	.15715
42	.26178	.24782	.23478	.22262	.21125	.20062	.19069	.18138	.17267	.16450
43	.27087	.25678	.24360	.23129	.21977	.20898	.19888	.18941	.18053	.17220
44	.28025	.26603	.25273	.24027	.22860	.21766	.20740	.19777	.18873	.18023
45	.28987	.27555	.26212	.24953	.23772	.22664	.21622	.20644	.19724	.18858
46	.29976	.28533	.27179	.25908	.24714	.23591	.22536	.21542	.20606	.19725
47	.30987	.29535	.28171	.26889	.25682	.24546	.23476	.22468	.21518	.20621
48	.32023	.30563	.29190	.27897	.26678	.25530	.24447	.23425	.22460	.21549
49	.33082	.31615	.30234	.28931	.27702	.26543	.25447	.24412	.23434	.22509
50	.34166	.32694	.31306	.29995	.28756	.27586	.26479	.25432	.24441	.23502
51	.35274	.33798	.32404	.31085	.29838	.28658	.27541	.26482	.25479	.24528
52	.36402	.34924	.33525	.32200	.30946	.29757	.28630	.27561	.26547	.25584

Age	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
53	.37550	.36070	.34668	.33339	.32078	.30882	.29746	.28667	.27643	.26669
54	.38717	.37237	.35833	.34500	.33234	.32031	.30888	.29801	.28766	.27782
55	.39903	.38424	.37019	.35683	.34413	.33205	.32056	.30961	.29918	.28925
56	.41108	.39631	.38227	.36890	.35617	.34405	.33250	.32149	.31099	.30097
57	.42330	.40857	.39455	.38118	.36844	.35629	.34469	.33363	.32306	.31297
58	.43566	.42098	.40699	.39364	.38089	.36873	.35710	.34600	.33538	.32522
59	.44811	.43351	.41956	.40623	.39350	.38133	.36968	.35855	.34789	.33768
60	.46066	.44613	.43224	.41896	.40624	.39408	.38243	.37127	.36058	.35033
61	.47330	.45887	.44505	.43182	.41914	.40699	.39535	.38418	.37347	.36318
62	.48608	.47175	.45802	.44485	.43223	.42011	.40848	.39732	.38660	.37629
63	.49898	.48478	.47115	.45807	.44550	.43343	.42184	.41069	.39997	.38966
64	.51200	.49793	.48442	.47143	.45895	.44694	.43539	.42427	.41357	.40326
65	.52512	.51121	.49782	.48495	.47255	.46062	.44912	.43805	.42738	.41709
66	.53835	.52461	.51137	.49862	.48634	.47449	.46307	.45206	.44143	.43118
67	.55174	.53818	.52511	.51250	.50034	.48860	.47727	.46633	.45576	.44556
68	.56524	.55188	.53899	.52654	.51452	.50291	.49168	.48083	.47034	.46020
69	.57882	.56568	.55299	.54071	.52885	.51737	.50627	.49552	.48513	.47506
70	.59242	.57951	.56703	.55495	.54325	.53193	.52096	.51034	.50004	.49007
71	.60598	.59332	.58106	.56918	.55767	.54651	.53569	.52520	.51503	.50516
72	.61948	.60707	.59504	.58338	.57206	.56108	.55043	.54009	.53004	.52029
73	.63287	.62073	.60895	.59751	.58640	.57561	.56513	.55495	.54505	.53543
74	.64621	.63435	.62282	.61162	.60073	.59015	.57985	.56984	.56009	.55061
75	.65953	.64796	.63671	.62575	.61510	.60473	.59463	.58480	.57523	.56591
76	.67287	.66160	.65063	.63995	.62954	.61940	.60952	.59989	.59050	.58135
77	.68622	.67526	.66459	.65419	.64404	.63415	.62450	.61509	.60590	.59694
78	.69954	.68892	.67856	.66845	.65858	.64895	.63955	.63036	.62140	.61264
79	.71278	.70250	.69246	.68265	.67308	.66372	.65457	.64563	.63690	.62836
80	.72581	.71588	.70618	.69668	.68740	.67833	.66945	.66077	.65227	.64396
81	.73857	.72899	.71962	.71045	.70147	.69268	.68408	.67566	.66741	.65933
82	.75101	.74178	.73274	.72389	.71522	.70672	.69840	.69024	.68225	.67441
83	.76311	.75423	.74553	.73700	.72864	.72044	.71240	.70451	.69678	.68919
84	.77497	.76645	.75809	.74988	.74183	.73393	.72618	.71857	.71110	.70377
85	.78665	.77848	.77047	.76260	.75487	.74728	.73982	.73250	.72530	.71823
86	.79805	.79025	.78258	.77504	.76764	.76036	.75320	.74617	.73925	.73245
87	.80904	.80159	.79427	.78706	.77998	.77301	.76615	.75940	.75277	.74624
88	.81962	.81251	.80552	.79865	.79188	.78521	.77865	.77220	.76584	.75958
89	.82978	.82302	.81636	.80980	.80335	.79699	.79072	.78455	.77847	.77248
90	.83952	.83309	.82676	.82052	.81437	.80831	.80234	.79645	.79064	.78492
91	.84870	.84260	.83658	.83064	.82479	.81902	.81332	.80771	.80217	.79671
92	.85716	.85136	.84563	.83998	.83441	.82891	.82348	.81812	.81283	.80761
93	.86494	.85942	.85396	.84858	.84326	.83801	.83283	.82771	.82266	.81767
94	.87216	.86690	.86170	.85657	.85149	.84648	.84153	.83664	.83181	.82704
95	.87898	.87397	.86902	.86412	.85928	.85450	.84977	.84510	.84049	.83592
96	.88537	.88060	.87587	.87121	.86659	.86203	.85751	.85305	.84864	.84427
97	.89127	.88672	.88221	.87775	.87335	.86898	.86467	.86040	.85618	.85200
98	.89680	.89245	.88815	.88389	.87968	.87551	.87138	.86730	.86326	.85926
99	.90217	.89803	.89393	.88987	.88585	.88187	.87793	.87402	.87016	.86633
100	.90738	.90344	.89953	.89567	.89183	.88804	.88428	.88056	.87687	.87322
101	.91250	.90876	.90504	.90137	.89772	.89412	.89054	.88699	.88348	.88000
102	.91751	.91396	.91045	.90696	.90350	.90007	.89668	.89331	.88997	.88666
103	.92247	.91912	.91579	.91249	.90922	.90598	.90276	.89957	.89640	.89326
104	.92775	.92460	.92148	.91839	.91532	.91227	.90924	.90624	.90326	.90031
105	.93290	.92996	.92704	.92415	.92127	.91841	.91558	.91276	.90997	.90719
106	.93948	.93680	.93415	.93151	.92889	.92628	.92370	.92113	.91857	.91604
107	.94739	.94504	.94271	.94039	.93808	.93579	.93351	.93124	.92899	.92675
108	.95950	.95767	.95585	.95404	.95224	.95045	.94867	.94689	.94512	.94336
109	.97985	.97893	.97801	.97710	.97619	.97529	.97438	.97348	.97259	.97170

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03034	.02857	.02700	.02559	.02433	.02321	.02220	.02129	.02047	.01973
1	.02279	.02094	.01929	.01782	.01650	.01533	.01427	.01331	.01246	.01168
2	.02347	.02155	.01983	.01829	.01692	.01569	.01458	.01358	.01268	.01187
3	.02444	.02243	.02065	.01905	.01761	.01632	.01516	.01412	.01317	.01232
4	.02558	.02349	.02163	.01996	.01846	.01712	.01590	.01481	.01382	.01292
5	.02686	.02469	.02275	.02101	.01945	.01804	.01677	.01562	.01458	.01364
6	.02825	.02600	.02398	.02217	.02053	.01906	.01773	.01653	.01544	.01445
7	.02976	.02742	.02532	.02343	.02172	.02019	.01880	.01754	.01640	.01536
8	.03137	.02894	.02675	.02479	.02301	.02140	.01995	.01864	.01744	.01635
9	.03311	.03059	.02832	.02627	.02442	.02274	.02122	.01985	.01859	.01745
10	.03499	.03237	.03001	.02788	.02595	.02420	.02262	.02118	.01987	.01867
11	.03700	.03428	.03183	.02961	.02760	.02578	.02413	.02262	.02125	.02000
12	.03913	.03632	.03377	.03146	.02937	.02748	.02575	.02418	.02275	.02144
13	.04135	.03843	.03579	.03339	.03122	.02924	.02744	.02580	.02431	.02294

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
14	.04359	.04057	.03783	.03534	.03308	.03102	.02915	.02744	.02587	.02444
15	.04584	.04270	.03986	.03728	.03493	.03279	.03083	.02905	.02742	.02593
16	.04806	.04482	.04187	.03919	.03674	.03452	.03248	.03063	.02892	.02736
17	.05029	.04692	.04387	.04108	.03855	.03623	.03411	.03218	.03040	.02877
18	.05253	.04905	.04588	.04299	.04036	.03795	.03574	.03373	.03187	.03017
19	.05484	.05124	.04796	.04496	.04222	.03972	.03742	.03532	.03339	.03161
20	.05726	.05354	.05013	.04702	.04418	.04158	.03919	.03700	.03498	.03313
21	.05980	.05595	.05242	.04920	.04625	.04354	.04105	.03877	.03667	.03473
22	.06246	.05847	.05482	.05147	.04841	.04559	.04301	.04063	.03844	.03642
23	.06524	.06112	.05734	.05387	.05069	.04777	.04508	.04260	.04032	.03821
24	.06819	.06392	.06001	.05642	.05312	.05008	.04728	.04470	.04232	.04012
25	.07131	.06690	.06285	.05913	.05570	.05255	.04964	.04695	.04447	.04218
26	.07460	.07005	.06586	.06200	.05845	.05518	.05215	.04936	.04677	.04438
27	.07810	.07340	.06907	.06508	.06140	.05800	.05485	.05195	.04925	.04676
28	.08179	.07693	.07246	.06833	.06451	.06098	.05772	.05469	.05189	.04929
29	.08566	.08065	.07603	.07176	.06780	.06414	.06075	.05761	.05469	.05198
30	.08973	.08456	.07978	.07536	.07127	.06748	.06396	.06069	.05766	.05483
31	.09398	.08865	.08372	.07915	.07491	.07098	.06733	.06394	.06078	.05785
32	.09843	.09294	.08785	.08313	.07875	.07468	.07089	.06737	.06409	.06103
33	.10310	.09745	.09220	.08732	.08279	.07858	.07466	.07100	.06759	.06441
34	.10799	.10217	.09676	.09173	.08705	.08269	.07862	.07483	.07129	.06798
35	.11314	.10715	.10157	.09638	.09155	.08704	.08283	.07890	.07522	.07179
36	.11852	.11236	.10662	.10127	.09628	.09162	.08726	.08319	.07938	.07581
37	.12416	.11783	.11193	.10641	.10126	.09645	.09194	.08772	.08377	.08006
38	.13009	.12359	.11751	.11183	.10652	.10155	.09689	.09253	.08843	.08459
39	.13629	.12962	.12338	.11753	.11206	.10693	.10212	.09761	.09337	.08938
40	.14281	.13597	.12955	.12355	.11791	.11262	.10766	.10299	.09860	.09447
41	.14966	.14264	.13606	.12989	.12409	.11864	.11352	.10870	.10417	.09989
42	.15685	.14966	.14291	.13657	.13061	.12500	.11972	.11475	.11006	.10564
43	.16437	.15702	.15010	.14360	.13747	.13171	.12627	.12115	.11631	.11174
44	.17224	.16472	.15764	.15098	.14469	.13876	.13317	.12789	.12290	.11819
45	.18042	.17274	.16550	.15867	.15223	.14615	.14040	.13496	.12982	.12496
46	.18893	.18110	.17370	.16671	.16011	.15387	.14796	.14238	.13708	.13207
47	.19775	.18975	.18220	.17505	.16830	.16190	.15584	.15010	.14466	.13950
48	.20688	.19873	.19102	.18373	.17682	.17027	.16406	.15817	.15258	.14727
49	.21633	.20804	.20018	.19274	.18568	.17898	.17262	.16658	.16084	.15539
50	.22612	.21769	.20969	.20210	.19490	.18805	.18155	.17536	.16948	.16388
51	.23625	.22769	.21955	.21182	.20448	.19749	.19084	.18452	.17849	.17275
52	.24669	.23799	.22973	.22186	.21438	.20726	.20047	.19400	.18784	.18196
53	.25742	.24861	.24022	.23222	.22461	.21735	.21043	.20383	.19753	.19151
54	.26845	.25952	.25101	.24290	.23516	.22777	.22072	.21399	.20756	.20140
55	.27978	.27074	.26212	.25389	.24604	.23853	.23136	.22450	.21793	.21166
56	.29140	.28227	.27355	.26522	.25725	.24963	.24233	.23535	.22867	.22227
57	.30333	.29411	.28529	.27686	.26879	.26106	.25365	.24656	.23976	.23324
58	.31551	.30621	.29731	.28878	.28061	.27278	.26528	.25807	.25116	.24453
59	.32790	.31854	.30956	.30095	.29269	.28477	.27716	.26986	.26284	.25610
60	.34050	.33107	.32202	.31334	.30500	.29699	.28929	.28190	.27478	.26794
61	.35331	.34384	.33473	.32598	.31757	.30948	.30170	.29422	.28701	.28007
62	.36639	.35688	.34772	.33892	.33044	.32229	.31443	.30687	.29958	.29255
63	.37974	.37020	.36101	.35216	.34363	.33542	.32750	.31986	.31250	.30539
64	.39334	.38378	.37456	.36568	.35711	.34884	.34087	.33317	.32574	.31857
65	.40718	.39761	.38838	.37947	.37087	.36257	.35455	.34681	.33932	.33208
66	.42128	.41172	.40249	.39357	.38496	.37663	.36858	.36079	.35326	.34597
67	.43569	.42616	.41694	.40803	.39941	.39107	.38299	.37518	.36761	.36028
68	.45038	.44089	.43170	.42281	.41419	.40585	.39777	.38994	.38235	.37499
69	.46531	.45587	.44672	.43786	.42927	.42094	.41286	.40503	.39743	.39006
70	.48040	.47103	.46194	.45312	.44456	.43626	.42820	.42038	.41278	.40540
71	.49558	.48629	.47727	.46851	.46000	.45174	.44371	.43591	.42832	.42095
72	.51082	.50162	.49268	.48399	.47554	.46733	.45934	.45157	.44401	.43666
73	.52607	.51697	.50813	.49952	.49114	.48299	.47506	.46733	.45981	.45249
74	.54139	.53241	.52367	.51515	.50686	.49879	.49092	.48325	.47578	.46849
75	.55683	.54798	.53936	.53095	.52276	.51477	.50698	.49938	.49197	.48474
76	.57243	.56373	.55524	.54696	.53888	.53100	.52330	.51579	.50846	.50130
77	.58819	.57965	.57132	.56318	.55523	.54747	.53988	.53247	.52523	.51815
78	.60408	.59572	.58755	.57957	.57177	.56414	.55668	.54939	.54225	.53527
79	.62001	.61184	.60385	.59604	.58840	.58092	.57360	.56644	.55943	.55256
80	.63582	.62786	.62007	.61244	.60497	.59765	.59048	.58347	.57659	.56985
81	.65142	.64367	.63608	.62864	.62135	.61421	.60721	.60034	.59361	.58701
82	.66673	.65920	.65182	.64458	.63748	.63052	.62368	.61698	.61041	.60395
83	.68175	.67444	.66728	.66024	.65334	.64656	.63991	.63338	.62696	.62066
84	.69657	.68950	.68256	.67574	.66904	.66246	.65599	.64964	.64340	.63727
85	.71128	.70446	.69775	.69116	.68467	.67830	.67204	.66587	.65982	.65386
86	.72576	.71919	.71272	.70636	.70010	.69394	.68789	.68193	.67606	.67029
87	.73981	.73349	.72726	.72114	.71511	.70917	.70333	.69757	.69190	.68632

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
88	.75342	.74735	.74137	.73548	.72968	.72396	.71833	.71279	.70732	.70194
89	.76658	.76076	.75503	.74938	.74381	.73832	.73290	.72757	.72231	.71712
90	.77928	.77371	.76823	.76281	.75748	.75221	.74702	.74190	.73684	.73186
91	.79131	.78600	.78075	.77557	.77046	.76542	.76044	.75553	.75068	.74589
92	.80246	.79737	.79235	.78740	.78250	.77767	.77290	.76818	.76353	.75893
93	.81274	.80788	.80307	.79832	.79363	.78899	.78441	.77989	.77542	.77100
94	.82232	.81766	.81306	.80850	.80401	.79956	.79517	.79082	.78653	.78228
95	.83141	.82695	.82254	.81818	.81387	.80961	.80539	.80122	.79710	.79302
96	.83996	.83569	.83147	.82729	.82316	.81907	.81503	.81103	.80707	.80315
97	.84787	.84378	.83973	.83573	.83176	.82784	.82396	.82012	.81632	.81255
98	.85530	.85138	.84750	.84366	.83985	.83609	.83236	.82867	.82502	.82140
99	.86255	.85880	.85508	.85140	.84776	.84415	.84057	.83703	.83353	.83005
100	.86960	.86601	.86246	.85894	.85546	.85200	.84858	.84519	.84183	.83849
101	.87655	.87313	.86974	.86638	.86305	.85975	.85648	.85324	.85003	.84684
102	.88338	.88012	.87689	.87369	.87052	.86738	.86426	.86116	.85809	.85505
103	.89015	.88706	.88399	.88095	.87793	.87494	.87197	.86903	.86611	.86321
104	.89737	.89446	.89157	.88871	.88586	.88304	.88024	.87745	.87469	.87195
105	.90443	.90170	.89898	.89628	.89360	.89094	.88830	.88568	.88307	.88049
106	.91351	.91101	.90852	.90605	.90359	.90115	.89873	.89632	.89392	.89154
107	.92452	.92230	.92010	.91791	.91573	.91356	.91141	.90927	.90714	.90502
108	.94161	.93987	.93814	.93641	.93469	.93298	.93128	.92958	.92790	.92622
109	.97081	.96992	.96904	.96816	.96729	.96642	.96555	.96468	.96382	.96296

Age	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
0	.01906	.01845	.01790	.01740	.01694	.01652	.01613	.01578	.01546	.01516
1	.01098	.01034	.00977	.00924	.00876	.00833	.00793	.00756	.00722	.00691
2	.01113	.01046	.00986	.00930	.00880	.00834	.00791	.00753	.00717	.00684
3	.01155	.01084	.01020	.00962	.00909	.00860	.00816	.00775	.00737	.00702
4	.01211	.01137	.01069	.01008	.00952	.00900	.00853	.00810	.00770	.00733
5	.01279	.01201	.01130	.01065	.01006	.00952	.00902	.00856	.00814	.00775
6	.01356	.01274	.01199	.01131	.01068	.01011	.00959	.00910	.00865	.00824
7	.01442	.01356	.01277	.01205	.01140	.01079	.01023	.00972	.00925	.00881
8	.01536	.01446	.01363	.01287	.01218	.01154	.01096	.01041	.00991	.00945
9	.01641	.01546	.01460	.01380	.01307	.01240	.01178	.01120	.01068	.01019
10	.01758	.01659	.01567	.01484	.01407	.01336	.01270	.01210	.01154	.01103
11	.01886	.01781	.01686	.01598	.01517	.01442	.01373	.01310	.01251	.01196
12	.02024	.01915	.01814	.01721	.01636	.01558	.01485	.01419	.01357	.01299
13	.02168	.02054	.01948	.01851	.01762	.01679	.01603	.01533	.01467	.01407
14	.02313	.02193	.02083	.01981	.01887	.01801	.01721	.01646	.01578	.01514
15	.02456	.02330	.02214	.02107	.02009	.01918	.01834	.01756	.01684	.01617
16	.02593	.02462	.02340	.02229	.02126	.02030	.01942	.01860	.01785	.01714
17	.02728	.02590	.02463	.02346	.02238	.02138	.02046	.01960	.01880	.01806
18	.02861	.02717	.02584	.02462	.02348	.02243	.02146	.02056	.01972	.01894
19	.02998	.02847	.02708	.02580	.02461	.02351	.02249	.02154	.02066	.01984
20	.03142	.02984	.02839	.02704	.02580	.02465	.02357	.02258	.02165	.02079
21	.03295	.03130	.02978	.02837	.02706	.02585	.02473	.02368	.02271	.02180
22	.03455	.03283	.03124	.02976	.02839	.02712	.02594	.02484	.02382	.02286
23	.03626	.03446	.03279	.03124	.02981	.02847	.02723	.02608	.02500	.02400
24	.03809	.03620	.03446	.03283	.03133	.02993	.02863	.02741	.02628	.02522
25	.04005	.03808	.03625	.03456	.03298	.03151	.03014	.02887	.02768	.02656
26	.04216	.04010	.03819	.03641	.03476	.03322	.03178	.03044	.02919	.02802
27	.04444	.04229	.04029	.03843	.03670	.03508	.03357	.03217	.03085	.02962
28	.04687	.04463	.04254	.04059	.03877	.03708	.03550	.03402	.03263	.03133
29	.04946	.04712	.04493	.04289	.04099	.03922	.03756	.03600	.03455	.03318
30	.05221	.04976	.04748	.04534	.04335	.04149	.03975	.03812	.03659	.03515
31	.05511	.05255	.05017	.04794	.04585	.04390	.04208	.04037	.03876	.03725
32	.05818	.05551	.05302	.05069	.04851	.04647	.04455	.04276	.04107	.03948
33	.06144	.05866	.05606	.05363	.05135	.04921	.04720	.04532	.04355	.04188
34	.06489	.06200	.05928	.05674	.05436	.05212	.05002	.04805	.04619	.04444
35	.06857	.06555	.06273	.06007	.05758	.05524	.05304	.05097	.04902	.04718
36	.07246	.06932	.06638	.06361	.06101	.05856	.05626	.05409	.05205	.05012
37	.07659	.07332	.07025	.06737	.06466	.06210	.05969	.05742	.05528	.05325
38	.08098	.07758	.07439	.07138	.06855	.06588	.06336	.06099	.05874	.05662
39	.08563	.08210	.07878	.07565	.07270	.06992	.06729	.06480	.06245	.06023
40	.09059	.08692	.08347	.08021	.07714	.07423	.07149	.06889	.06643	.06411
41	.09586	.09206	.08848	.08509	.08189	.07886	.07600	.07329	.07072	.06828
42	.10147	.09753	.09381	.09029	.08696	.08381	.08083	.07800	.07531	.07277
43	.10742	.10334	.09948	.09583	.09237	.08909	.08598	.08304	.08024	.07758
44	.11373	.10950	.10551	.10172	.09813	.09472	.09148	.08841	.08549	.08272
45	.12035	.11599	.11185	.10792	.10420	.10066	.09730	.09410	.09106	.08817
46	.12732	.12281	.11853	.11447	.11061	.10694	.10345	.10013	.09696	.09395
47	.13460	.12995	.12553	.12133	.11733	.11353	.10991	.10646	.10317	.10004
48	.14223	.13743	.13287	.12853	.12439	.12046	.11671	.11313	.10972	.10646

Age	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
49	.15020	.14526	.14056	.13608	.13181	.12774	.12385	.12015	.11661	.11322
50	.15855	.15347	.14862	.14401	.13960	.13540	.13138	.12754	.12388	.12037
51	.16727	.16205	.15707	.15232	.14777	.14344	.13929	.13532	.13153	.12789
52	.17634	.17098	.16587	.16097	.15630	.15183	.14755	.14345	.13953	.13577
53	.18576	.18027	.17501	.16999	.16518	.16057	.15616	.15194	.14789	.14400
54	.19552	.18990	.18451	.17935	.17441	.16968	.16514	.16078	.15661	.15260
55	.20564	.19989	.19437	.18908	.18402	.17915	.17449	.17001	.16571	.16157
56	.21613	.21025	.20461	.19919	.19400	.18901	.18422	.17962	.17519	.17093
57	.22698	.22098	.21522	.20968	.20436	.19925	.19434	.18961	.18507	.18069
58	.23816	.23204	.22616	.22051	.21507	.20984	.20481	.19996	.19530	.19080
59	.24962	.24339	.23740	.23163	.22608	.22073	.21558	.21062	.20584	.20123
60	.26136	.25502	.24892	.24304	.23738	.23192	.22666	.22158	.21669	.21196
61	.27339	.26695	.26075	.25477	.24900	.24343	.23806	.23288	.22787	.22304
62	.28578	.27925	.27295	.26687	.26100	.25533	.24985	.24456	.23945	.23451
63	.29854	.29192	.28553	.27935	.27339	.26762	.26205	.25666	.25145	.24641
64	.31164	.30494	.29846	.29221	.28615	.28030	.27463	.26915	.26384	.25870
65	.32508	.31831	.31177	.30543	.29930	.29336	.28761	.28203	.27663	.27140
66	.33891	.33208	.32547	.31906	.31285	.30684	.30101	.29536	.28987	.28456
67	.35318	.34630	.33963	.33316	.32689	.32081	.31491	.30918	.30363	.29823
68	.36785	.36093	.35422	.34770	.34138	.33524	.32928	.32349	.31787	.31240
69	.38290	.37595	.36920	.36265	.35628	.35009	.34408	.33824	.33256	.32703
70	.39823	.39127	.38450	.37791	.37151	.36529	.35924	.35335	.34762	.34204
71	.41378	.40681	.40003	.39343	.38701	.38076	.37467	.36875	.36298	.35736
72	.42950	.42253	.41575	.40914	.40271	.39644	.39034	.38438	.37858	.37293
73	.44535	.43840	.43162	.42502	.41858	.41231	.40619	.40022	.39440	.38872
74	.46139	.45446	.44771	.44112	.43469	.42842	.42230	.41632	.41049	.40479
75	.47769	.47080	.46408	.45752	.45111	.44485	.43874	.43277	.42693	.42123
76	.49430	.48747	.48079	.47427	.46790	.46167	.45558	.44963	.44380	.43811
77	.51123	.50447	.49786	.49139	.48506	.47888	.47282	.46690	.46111	.45543
78	.52845	.52177	.51523	.50884	.50257	.49645	.49044	.48457	.47881	.47317
79	.54584	.53926	.53282	.52650	.52032	.51426	.50833	.50251	.49681	.49122
80	.56325	.55678	.55044	.54423	.53813	.53216	.52630	.52056	.51492	.50939
81	.58054	.57419	.56797	.56186	.55587	.54999	.54422	.53856	.53300	.52754
82	.59762	.59140	.58530	.57931	.57343	.56766	.56198	.55641	.55094	.54557
83	.61448	.60840	.60243	.59657	.59081	.58515	.57958	.57411	.56874	.56346
84	.63124	.62531	.61949	.61376	.60813	.60259	.59715	.59179	.58652	.58134
85	.64800	.64224	.63657	.63099	.62550	.62010	.61478	.60955	.60441	.59934
86	.66461	.65902	.65351	.64810	.64276	.63751	.63233	.62724	.62222	.61728
87	.68083	.67541	.67008	.66483	.65965	.65455	.64953	.64458	.63970	.63489
88	.69663	.69140	.68624	.68116	.67615	.67121	.66634	.66154	.65680	.65213
89	.71201	.70696	.70199	.69708	.69224	.68747	.68276	.67811	.67353	.66900
90	.72694	.72209	.71730	.71257	.70791	.70330	.69876	.69427	.68984	.68547
91	.74117	.73650	.73190	.72735	.72286	.71842	.71404	.70972	.70545	.70123
92	.75439	.74991	.74548	.74110	.73678	.73251	.72829	.72412	.72000	.71593
93	.76664	.76233	.75806	.75385	.74969	.74557	.74150	.73748	.73350	.72957
94	.77809	.77394	.76983	.76578	.76177	.75780	.75388	.75000	.74616	.74237
95	.78899	.78500	.78106	.77715	.77329	.76947	.76569	.76195	.75826	.75460
96	.79928	.79544	.79165	.78790	.78418	.78050	.77686	.77326	.76970	.76617
97	.80883	.80514	.80149	.79787	.79430	.79075	.78725	.78377	.78033	.77693
98	.81781	.81427	.81075	.80727	.80382	.80041	.79703	.79368	.79036	.78708
99	.82661	.82320	.81982	.81648	.81316	.80988	.80662	.80340	.80020	.79704
100	.83519	.83192	.82868	.82547	.82228	.81913	.81600	.81290	.80982	.80678
101	.84368	.84055	.83744	.83437	.83131	.82829	.82529	.82231	.81936	.81643
102	.85203	.84904	.84607	.84313	.84021	.83731	.83444	.83159	.82876	.82596
103	.86034	.85748	.85465	.85184	.84906	.84629	.84355	.84082	.83812	.83544
104	.86923	.86653	.86385	.86119	.85855	.85593	.85333	.85074	.84818	.84563
105	.87792	.87537	.87283	.87032	.86782	.86534	.86287	.86042	.85799	.85557
106	.88918	.88683	.88450	.88218	.87987	.87758	.87530	.87304	.87079	.86855
107	.90291	.90082	.89873	.89666	.89460	.89255	.89051	.88849	.88647	.88447
108	.92455	.92288	.92123	.91958	.91794	.91630	.91468	.91306	.91145	.90984
109	.96211	.96125	.96041	.95956	.95872	.95788	.95704	.95620	.95537	.95455

Age	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
0	.01488	.01463	.01439	.01417	.01396	.01377	.01359	.01343	.01327	.01312
1	.00662	.00636	.00612	.00589	.00568	.00548	.00530	.00513	.00497	.00482
2	.00654	.00626	.00600	.00576	.00554	.00533	.00514	.00496	.00479	.00463
3	.00670	.00641	.00613	.00588	.00564	.00542	.00522	.00502	.00484	.00468
4	.00699	.00668	.00639	.00612	.00587	.00563	.00542	.00521	.00502	.00484
5	.00739	.00706	.00675	.00646	.00620	.00595	.00571	.00550	.00529	.00510
6	.00786	.00751	.00718	.00687	.00659	.00633	.00608	.00585	.00563	.00543
7	.00841	.00803	.00769	.00736	.00706	.00678	.00652	.00627	.00604	.00582
8	.00902	.00863	.00826	.00791	.00759	.00730	.00702	.00675	.00651	.00628
9	.00973	.00931	.00892	.00856	.00822	.00790	.00760	.00733	.00706	.00682

Age	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
10	.01055	.01010	.00969	.00930	.00894	.00861	.00829	.00799	.00772	.00746
11	.01146	.01099	.01055	.01014	.00976	.00940	.00907	.00875	.00846	.00818
12	.01246	.01196	.01150	.01106	.01066	.01028	.00993	.00960	.00928	.00899
13	.01351	.01298	.01249	.01204	.01161	.01121	.01084	.01049	.01016	.00985
14	.01455	.01400	.01348	.01300	.01255	.01213	.01173	.01136	.01102	.01069
15	.01555	.01497	.01443	.01392	.01345	.01300	.01259	.01220	.01183	.01148
16	.01648	.01587	.01530	.01477	.01427	.01380	.01336	.01295	.01257	.01220
17	.01737	.01673	.01612	.01556	.01504	.01455	.01408	.01365	.01324	.01286
18	.01822	.01754	.01691	.01632	.01576	.01525	.01476	.01430	.01387	.01347
19	.01908	.01837	.01770	.01708	.01650	.01595	.01544	.01495	.01450	.01407
20	.01999	.01924	.01854	.01788	.01726	.01669	.01615	.01564	.01516	.01471
21	.02096	.02017	.01943	.01874	.01809	.01748	.01691	.01637	.01586	.01539
22	.02197	.02114	.02036	.01963	.01895	.01830	.01770	.01713	.01660	.01610
23	.02306	.02218	.02136	.02059	.01987	.01919	.01855	.01795	.01739	.01686
24	.02424	.02331	.02245	.02163	.02087	.02016	.01948	.01885	.01825	.01769
25	.02552	.02455	.02364	.02278	.02197	.02122	.02051	.01984	.01920	.01861
26	.02692	.02589	.02493	.02403	.02318	.02238	.02162	.02091	.02025	.01961
27	.02846	.02738	.02636	.02541	.02451	.02367	.02287	.02212	.02141	.02074
28	.03012	.02898	.02791	.02690	.02595	.02506	.02422	.02342	.02267	.02196
29	.03190	.03070	.02957	.02851	.02751	.02656	.02567	.02483	.02404	.02329
30	.03381	.03254	.03135	.03023	.02917	.02817	.02723	.02634	.02551	.02471
31	.03583	.03450	.03324	.03206	.03094	.02989	.02890	.02796	.02707	.02623
32	.03799	.03659	.03527	.03402	.03284	.03173	.03068	.02968	.02874	.02785
33	.04031	.03883	.03744	.03612	.03488	.03371	.03260	.03155	.03055	.02961
34	.04279	.04123	.03976	.03838	.03707	.03583	.03465	.03354	.03249	.03149
35	.04545	.04382	.04227	.04081	.03943	.03812	.03688	.03571	.03459	.03354
36	.04830	.04658	.04495	.04341	.04196	.04058	.03927	.03803	.03685	.03573
37	.05134	.04953	.04782	.04620	.04467	.04321	.04183	.04052	.03928	.03809
38	.05462	.05272	.05092	.04921	.04760	.04606	.04461	.04322	.04191	.04066
39	.05812	.05613	.05424	.05245	.05075	.04913	.04760	.04614	.04475	.04343
40	.06190	.05981	.05782	.05594	.05415	.05245	.05083	.04929	.04783	.04643
41	.06597	.06378	.06170	.05972	.05784	.05605	.05435	.05272	.05118	.04970
42	.07035	.06806	.06587	.06380	.06182	.05994	.05815	.05644	.05481	.05326
43	.07505	.07265	.07036	.06818	.06611	.06414	.06225	.06045	.05874	.05710
44	.08008	.07757	.07518	.07290	.07072	.06865	.06667	.06478	.06298	.06125
45	.08542	.08279	.08029	.07791	.07563	.07346	.07138	.06940	.06750	.06569
46	.09108	.08834	.08573	.08324	.08085	.07858	.07640	.07432	.07233	.07043
47	.09705	.09419	.09147	.08886	.08637	.08399	.08172	.07954	.07745	.07545
48	.10335	.10038	.09754	.09482	.09222	.08973	.08735	.08507	.08288	.08078
49	.10999	.10690	.10394	.10111	.09840	.09581	.09332	.09093	.08864	.08644
50	.11701	.11380	.11073	.10778	.10496	.10225	.09965	.09716	.09477	.09247
51	.12441	.12108	.11789	.11482	.11189	.10907	.10636	.10376	.10126	.09886
52	.13217	.12871	.12540	.12222	.11916	.11623	.11341	.11071	.10810	.10560
53	.14028	.13670	.13327	.12997	.12680	.12375	.12082	.11801	.11529	.11268
54	.14875	.14505	.14150	.13808	.13480	.13163	.12859	.12566	.12284	.12012
55	.15760	.15378	.15011	.14657	.14317	.13989	.13674	.13370	.13077	.12794
56	.16684	.16290	.15911	.15546	.15194	.14855	.14528	.14213	.13909	.13615
57	.17648	.17242	.16851	.16474	.16111	.15760	.15422	.15096	.14781	.14477
58	.18647	.18229	.17827	.17438	.17064	.16702	.16353	.16015	.15689	.15374
59	.19678	.19249	.18835	.18435	.18049	.17676	.17316	.16968	.16631	.16305
60	.20740	.20300	.19875	.19464	.19066	.18682	.18311	.17952	.17604	.17268
61	.21837	.21385	.20949	.20527	.20119	.19724	.19341	.18971	.18613	.18266
62	.22973	.22511	.22064	.21631	.21212	.20807	.20414	.20033	.19664	.19306
63	.24152	.23680	.23222	.22779	.22350	.21934	.21530	.21139	.20760	.20392
64	.25372	.24890	.24422	.23969	.23529	.23103	.22690	.22289	.21899	.21521
65	.26633	.26141	.25664	.25201	.24752	.24316	.23893	.23482	.23083	.22695
66	.27940	.27439	.26953	.26481	.26023	.25577	.25145	.24724	.24316	.23918
67	.29299	.28790	.28296	.27815	.27348	.26894	.26453	.26024	.25606	.25200
68	.30709	.30193	.29691	.29202	.28728	.28265	.27816	.27378	.26952	.26537
69	.32166	.31643	.31134	.30639	.30157	.29687	.29230	.28785	.28351	.27928
70	.33661	.33133	.32618	.32116	.31628	.31152	.30688	.30235	.29794	.29364
71	.35188	.34654	.34134	.33627	.33133	.32651	.32181	.31722	.31275	.30838
72	.36742	.36204	.35679	.35168	.34668	.34181	.33706	.33241	.32788	.32345
73	.38317	.37776	.37248	.36733	.36229	.35738	.35257	.34788	.34330	.33882
74	.39923	.39380	.38849	.38330	.37823	.37328	.36844	.36370	.35908	.35455
75	.41566	.41021	.40489	.39968	.39459	.38961	.38474	.37997	.37531	.37074
76	.43254	.42709	.42176	.41655	.41144	.40645	.40156	.39677	.39208	.38749
77	.44988	.44444	.43912	.43391	.42880	.42380	.41891	.41411	.40940	.40479
78	.46765	.46224	.45694	.45174	.44665	.44166	.43677	.43197	.42726	.42265
79	.48574	.48037	.47510	.46993	.46487	.45990	.45502	.45024	.44554	.44094
80	.50397	.49865	.49343	.48830	.48327	.47834	.47349	.46873	.46406	.45947
81	.52219	.51693	.51176	.50669	.50171	.49682	.49201	.48729	.48265	.47809
82	.54029	.53510	.53000	.52499	.52007	.51523	.51047	.50580	.50120	.49667
83	.55826	.55315	.54813	.54319	.53834	.53356	.52886	.52424	.51969	.51522

Age	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
84	.57624	.57123	.56629	.56144	.55666	.55195	.54732	.54277	.53828	.53386
85	.59435	.58944	.58460	.57984	.57516	.57054	.56599	.56151	.55710	.55275
86	.61241	.60762	.60289	.59824	.59365	.58913	.58468	.58029	.57596	.57170
87	.63015	.62548	.62087	.61633	.61185	.60744	.60309	.59880	.59456	.59039
88	.64753	.64299	.63851	.63409	.62973	.62543	.62118	.61700	.61287	.60879
89	.66454	.66013	.65579	.65150	.64726	.64308	.63895	.63488	.63086	.62689
90	.68115	.67689	.67268	.66853	.66442	.66037	.65637	.65241	.64851	.64465
91	.69706	.69294	.68887	.68486	.68089	.67696	.67309	.66925	.66547	.66173
92	.71190	.70792	.70399	.70011	.69627	.69247	.68872	.68501	.68134	.67771
93	.72569	.72184	.71804	.71429	.71057	.70689	.70326	.69967	.69611	.69259
94	.73861	.73490	.73123	.72759	.72400	.72044	.71692	.71344	.71000	.70659
95	.75097	.74739	.74384	.74033	.73686	.73342	.73002	.72665	.72331	.72001
96	.76267	.75922	.75579	.75240	.74905	.74572	.74243	.73917	.73595	.73275
97	.77356	.77022	.76691	.76363	.76039	.75718	.75399	.75084	.74772	.74463
98	.78382	.78059	.77740	.77423	.77110	.76799	.76491	.76186	.75884	.75584
99	.79390	.79079	.78771	.78465	.78162	.77862	.77565	.77270	.76978	.76688
100	.80376	.80076	.79779	.79485	.79193	.78904	.78617	.78333	.78051	.77771
101	.81353	.81066	.80780	.80497	.80217	.79938	.79662	.79388	.79117	.78847
102	.82318	.82042	.81768	.81496	.81227	.80960	.80694	.80431	.80170	.79911
103	.83278	.83014	.82752	.82491	.82233	.81977	.81723	.81470	.81220	.80971
104	.84310	.84059	.83810	.83563	.83317	.83073	.82831	.82591	.82352	.82115
105	.85318	.85079	.84843	.84607	.84374	.84142	.83911	.83682	.83455	.83229
106	.86633	.86413	.86193	.85975	.85758	.85543	.85329	.85116	.84904	.84694
107	.88247	.88049	.87852	.87656	.87460	.87266	.87073	.86881	.86690	.86500
108	.90825	.90666	.90507	.90350	.90193	.90037	.89881	.89727	.89572	.89419
109	.95372	.95290	.95208	.95126	.95045	.94964	.94883	.94803	.94723	.94643

Age	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
0	.01298	.01285	.01273	.01261	.01250	.01240	.01230	.01221	.01212	.01203
1	.00468	.00455	.00443	.00431	.00420	.00410	.00400	.00391	.00382	.00374
2	.00448	.00435	.00421	.00409	.00398	.00387	.00376	.00366	.00357	.00348
3	.00452	.00437	.00423	.00410	.00398	.00386	.00375	.00365	.00355	.00345
4	.00468	.00452	.00437	.00423	.00410	.00397	.00386	.00375	.00364	.00354
5	.00493	.00476	.00460	.00445	.00431	.00418	.00405	.00393	.00382	.00371
6	.00524	.00506	.00489	.00473	.00458	.00444	.00430	.00418	.00406	.00394
7	.00562	.00543	.00525	.00508	.00492	.00477	.00462	.00449	.00436	.00423
8	.00606	.00586	.00566	.00548	.00531	.00515	.00499	.00485	.00471	.00458
9	.00659	.00637	.00616	.00597	.00579	.00561	.00545	.00529	.00514	.00500
10	.00721	.00698	.00676	.00655	.00636	.00617	.00600	.00583	.00567	.00552
11	.00792	.00767	.00744	.00722	.00701	.00682	.00663	.00645	.00628	.00612
12	.00871	.00845	.00821	.00797	.00775	.00754	.00735	.00716	.00698	.00681
13	.00955	.00928	.00902	.00877	.00854	.00831	.00810	.00790	.00771	.00753
14	.01038	.01009	.00981	.00955	.00930	.00907	.00885	.00864	.00843	.00824
15	.01116	.01085	.01056	.01028	.01002	.00977	.00954	.00932	.00910	.00890
16	.01186	.01153	.01123	.01094	.01066	.01040	.01015	.00992	.00969	.00948
17	.01250	.01215	.01183	.01152	.01124	.01096	.01070	.01045	.01022	.00999
18	.01308	.01272	.01238	.01206	.01175	.01147	.01119	.01093	.01068	.01044
19	.01367	.01329	.01293	.01259	.01227	.01196	.01167	.01140	.01113	.01088
20	.01428	.01388	.01350	.01314	.01280	.01248	.01217	.01188	.01161	.01134
21	.01494	.01451	.01411	.01373	.01337	.01303	.01271	.01240	.01211	.01183
22	.01562	.01517	.01475	.01435	.01397	.01361	.01326	.01294	.01263	.01233
23	.01635	.01588	.01543	.01501	.01460	.01422	.01386	.01351	.01319	.01287
24	.01716	.01665	.01618	.01573	.01530	.01489	.01451	.01415	.01380	.01347
25	.01804	.01751	.01701	.01653	.01608	.01565	.01524	.01485	.01448	.01413
26	.01902	.01845	.01792	.01741	.01693	.01648	.01604	.01563	.01524	.01487
27	.02011	.01951	.01895	.01841	.01790	.01742	.01696	.01652	.01610	.01571
28	.02129	.02066	.02006	.01949	.01895	.01844	.01795	.01748	.01704	.01662
29	.02258	.02191	.02127	.02067	.02009	.01955	.01903	.01853	.01806	.01762
30	.02396	.02325	.02257	.02193	.02132	.02074	.02019	.01966	.01916	.01869
31	.02543	.02467	.02396	.02328	.02263	.02201	.02143	.02087	.02034	.01983
32	.02701	.02621	.02545	.02472	.02404	.02338	.02276	.02217	.02160	.02106
33	.02871	.02786	.02706	.02629	.02556	.02487	.02420	.02357	.02297	.02240
34	.03054	.02964	.02879	.02797	.02720	.02646	.02576	.02509	.02445	.02383
35	.03253	.03158	.03067	.02981	.02898	.02820	.02745	.02674	.02606	.02541
36	.03467	.03366	.03269	.03178	.03090	.03007	.02928	.02852	.02779	.02710
37	.03697	.03590	.03488	.03391	.03298	.03209	.03125	.03044	.02967	.02893
38	.03947	.03833	.03725	.03622	.03524	.03430	.03340	.03254	.03172	.03094
39	.04217	.04096	.03982	.03873	.03768	.03669	.03573	.03482	.03395	.03312
40	.04510	.04383	.04262	.04146	.04035	.03930	.03828	.03732	.03639	.03550
41	.04830	.04695	.04567	.04445	.04327	.04215	.04108	.04005	.03907	.03812
42	.05177	.05035	.04900	.04770	.04646	.04527	.04413	.04304	.04200	.04100
43	.05553	.05404	.05261	.05123	.04992	.04866	.04746	.04630	.04520	.04413
44	.05960	.05802	.05651	.05506	.05368	.05235	.05107	.04985	.04867	.04754

Age	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
45	.06395	.06229	.06069	.05917	.05770	.05630	.05495	.05365	.05241	.05121
46	.06860	.06685	.06517	.06356	.06202	.06053	.05911	.05774	.05643	.05516
47	.07353	.07169	.06992	.06823	.06660	.06504	.06353	.06209	.06070	.05936
48	.07877	.07684	.07498	.07320	.07149	.06984	.06826	.06673	.06527	.06385
49	.08433	.08231	.08036	.07849	.07669	.07495	.07329	.07168	.07013	.06864
50	.09026	.08814	.08609	.08413	.08224	.08042	.07867	.07698	.07535	.07378
51	.09655	.09433	.09219	.09013	.08815	.08624	.08440	.08262	.08091	.07926
52	.10318	.10086	.09863	.09647	.09439	.09239	.09046	.08860	.08680	.08506
53	.11017	.10774	.10541	.10315	.10098	.09888	.09686	.09491	.09302	.09120
54	.11750	.11498	.11254	.11019	.10792	.10572	.10361	.10156	.09958	.09767
55	.12522	.12258	.12005	.11759	.11522	.11294	.11072	.10859	.10652	.10451
56	.13332	.13059	.12794	.12539	.12292	.12054	.11823	.11599	.11383	.11174
57	.14183	.13899	.13624	.13359	.13102	.12853	.12613	.12380	.12154	.11936
58	.15070	.14775	.14490	.14215	.13948	.13689	.13439	.13197	.12962	.12734
59	.15990	.15685	.15389	.15103	.14826	.14558	.14298	.14046	.13801	.13564
60	.16942	.16626	.16321	.16024	.15737	.15459	.15189	.14927	.14673	.14426
61	.17929	.17603	.17287	.16981	.16684	.16395	.16115	.15844	.15580	.15324
62	.18960	.18623	.18297	.17980	.17673	.17375	.17085	.16803	.16530	.16264
63	.20035	.19688	.19352	.19025	.18708	.18400	.18100	.17809	.17525	.17250
64	.21154	.20797	.20451	.20114	.19787	.19469	.19159	.18859	.18566	.18281
65	.22318	.21951	.21595	.21249	.20912	.20584	.20265	.19955	.19652	.19358
66	.23532	.23156	.22790	.22434	.22088	.21751	.21422	.21102	.20791	.20487
67	.24804	.24419	.24044	.23679	.23324	.22977	.22640	.22311	.21990	.21678
68	.26133	.25740	.25356	.24983	.24618	.24263	.23917	.23579	.23250	.22929
69	.27516	.27114	.26723	.26341	.25969	.25605	.25251	.24905	.24567	.24237
70	.28945	.28536	.28137	.27747	.27367	.26996	.26633	.26279	.25934	.25596
71	.30412	.29996	.29590	.29193	.28806	.28427	.28057	.27696	.27343	.26998
72	.31913	.31491	.31078	.30675	.30281	.29895	.29519	.29150	.28790	.28438
73	.33444	.33016	.32597	.32188	.31788	.31396	.31013	.30638	.30271	.29913
74	.35012	.34579	.34155	.33741	.33335	.32938	.32549	.32168	.31795	.31430
75	.36628	.36190	.35762	.35343	.34932	.34530	.34136	.33750	.33372	.33001
76	.38299	.37858	.37427	.37004	.36589	.36183	.35784	.35394	.35011	.34636
77	.40028	.39585	.39151	.38725	.38307	.37898	.37496	.37103	.36716	.36337
78	.41812	.41368	.40933	.40506	.40086	.39675	.39271	.38874	.38485	.38103
79	.43641	.43198	.42762	.42334	.41914	.41502	.41096	.40698	.40308	.39924
80	.45496	.45054	.44619	.44192	.43772	.43360	.42954	.42556	.42164	.41779
81	.47360	.46920	.46487	.46061	.45643	.45231	.44827	.44429	.44038	.43653
82	.49223	.48785	.48355	.47932	.47516	.47106	.46703	.46307	.45916	.45532
83	.51081	.50648	.50221	.49802	.49388	.48982	.48581	.48187	.47799	.47416
84	.52951	.52523	.52101	.51686	.51277	.50874	.50477	.50086	.49701	.49321
85	.54847	.54425	.54009	.53600	.53196	.52798	.52406	.52019	.51638	.51262
86	.56749	.56335	.55926	.55523	.55126	.54734	.54348	.53966	.53591	.53220
87	.58627	.58221	.57820	.57425	.57035	.56650	.56270	.55895	.55526	.55161
88	.60477	.60079	.59688	.59301	.58919	.58542	.58170	.57802	.57439	.57081
89	.62297	.61909	.61527	.61149	.60776	.60408	.60044	.59685	.59330	.58979
90	.64084	.63707	.63335	.62968	.62604	.62246	.61891	.61540	.61194	.60851
91	.65803	.65437	.65076	.64719	.64366	.64017	.63672	.63330	.62993	.62659
92	.67412	.67058	.66707	.66360	.66017	.65678	.65342	.65010	.64682	.64357
93	.68911	.68567	.68227	.67890	.67557	.67227	.66901	.66578	.66258	.65942
94	.70321	.69988	.69657	.69330	.69006	.68686	.68369	.68055	.67744	.67437
95	.71674	.71351	.71031	.70713	.70399	.70088	.69781	.69476	.69174	.68875
96	.72959	.72646	.72335	.72028	.71724	.71422	.71123	.70828	.70534	.70244
97	.74156	.73853	.73552	.73254	.72959	.72666	.72376	.72089	.71804	.71522
98	.75287	.74993	.74702	.74413	.74126	.73842	.73561	.73282	.73006	.72732
99	.76401	.76117	.75834	.75555	.75277	.75002	.74730	.74459	.74191	.73926
100	.77494	.77219	.76946	.76676	.76408	.76142	.75878	.75616	.75357	.75099
101	.78580	.78315	.78052	.77791	.77532	.77275	.77021	.76768	.76517	.76268
102	.79654	.79399	.79146	.78894	.78645	.78397	.78152	.77908	.77666	.77426
103	.80724	.80479	.80236	.79994	.79755	.79517	.79280	.79046	.78813	.78582
104	.81879	.81646	.81413	.81183	.80954	.80726	.80501	.80276	.80054	.79832
105	.83005	.82782	.82560	.82340	.82121	.81904	.81688	.81474	.81260	.81049
106	.84485	.84277	.84071	.83866	.83662	.83459	.83257	.83057	.82857	.82659
107	.86311	.86124	.85937	.85751	.85566	.85382	.85199	.85017	.84835	.84655
108	.89266	.89114	.88963	.88812	.88662	.88513	.88364	.88216	.88068	.87922
109	.94563	.94484	.94405	.94326	.94248	.94170	.94092	.94014	.93937	.93860

(f) *Effective dates.* This section applies after April 30, 1999.

[T.D. 7105, 36 FR 6480, Apr. 6, 1971; 36 FR 9512, May 26, 1971; 36 FR 12290, June 30, 1971, as amended by T.D. 7955, 49 FR 19976, May 11, 1984; T.D. 8540, 59 FR 30105, June 10, 1994; T.D. 8819, 64 FR 23190, Apr. 30, 1999; T.D. 8886, 65 FR 36910, June 12, 2000]

§ 1.642(c)–7 Transitional rules with respect to pooled income funds.

(a) *In general*—(1) *Amendment of certain funds.* A fund created before May 7, 1971, and not otherwise qualifying as a pooled income fund may be treated as a pooled income fund to which § 1.642(c)–5 applies if on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969, it possessed the initial characteristics described in paragraph (b) of this section and is amended, in the time and manner provided in paragraph (c) of this section, to meet all the requirements of section 642(c)(5) and § 1.642(c)–5. If a fund to which this subparagraph applies is amended in the time and manner provided in paragraph (c) of this section it shall be treated as provided in paragraph (d) of this section for the period beginning on August 1, 1969, or, if later, on the date of its creation and ending the day before the date on which it meets the requirements of section 642(c)(5) and § 1.642(c)–5.

(2) *Severance of a portion of a fund.* Any portion of a fund created before May 7, 1971, which consists of property transferred to such fund after July 31, 1969, may be severed from such fund consistently with the principles of paragraph (c)(2) of this section and established before January 1, 1972, as a separate pooled income fund, provided that on and after the date of severance the severed fund meets all the requirements of section 642(c)(5) and § 1.642(c)–5. A separate fund which is established pursuant to this subparagraph shall be treated as provided in paragraph (d) of this section for the period beginning on the day of the first transfer of property which becomes part of the separate fund and ending the day before the day on which the separate fund meets the requirements of section 642(c)(5) and § 1.642(c)–5.

(b) *Initial characteristics required.* A fund described in paragraph (a)(1) of this section shall not be treated as a pooled income fund to which section 642(c)(5) applies, even though it is amended as provided in paragraph (c) of this section, unless it possessed the following characteristics on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969:

(1) It satisfied the requirements of section 642(c)(5)(A) other than that the fund be a trust;

(2) It was constituted in a way to attract and contain commingled properties transferred to the fund by more than one donor satisfying such requirements; and

(3) Each beneficiary of a life income interest which was retained or created in any property transferred to the fund was entitled to receive, but not less often than annually, a proportional share of the annual income earned by the fund, such share being based on the fair market value of the property in which such life interest was retained or created.

(c) *Amendment requirements.* (1) A fund described in paragraph (a)(1) of this section and possessing the initial characteristics described in paragraph (b) of this section on the date prescribed therein shall be treated as a pooled income fund if it is amended to meet all the requirements of section 642(c)(5) and § 1.642(c)–5 before January 1, 1972, or, if later, on or before the 30th day after the date on which any judicial proceedings commenced before January 1, 1972, which are required to amend its governing instrument or any other instrument which does not permit it to meet such requirements, become final. However, see paragraph (d) of this section for limitation on the period in which a claim for credit or refund may be filed.

(2) In addition, if the transferred property described in paragraph (b)(2) of this section is commingled with other property, the transferred property must be separated on or before the date specified in subparagraph (1) of this paragraph from the other property and allocated to the fund in accordance with the transferred property's percentage share of the fair market value of the total commingled property on the date of separation. The percentage

share shall be the ratio which the fair market value of the transferred property on the date of separation bears to the fair market value of the total commingled property on that date and shall be computed in a manner consistent with paragraph (c) of § 1.642(c)–5. The property which is so allocated to the fund shall be treated as property received from transfers which meet the requirements of section 642(c)(5), and such transfers shall be treated as made on the dates on which the properties giving rise to such allocation were transferred to the fund by the respective donors. The property so allocated to the fund must be representative of all the commingled property other than securities the income from which is exempt from tax under subtitle A of the Code; compensating increases in other commingled property allocated to the fund shall be made where such tax-exempt securities are not allocated to the fund. The application of this subparagraph may be illustrated by the following example:

Example. (a) The trustees of X fund are in the process of amending it in order to qualify as a pooled income fund. The property transferred to the X fund was commingled with other property transferred to the organization by which the fund was established. After taking into account the various transfers and the appreciation in the fair market value of all the properties, the fair market value of the property allocated to the fund on the various transfer dates is set forth in the following schedule and determined in the manner indicated:

TRANSFERS

Date of transfer	Value of all property before transfer (1)	Trust property (2)	Other property (3)	Value of all property after transfer (4)	Property allocated to fund (5)
January 1, 1968	....	$100,000	$100,000	$200,000	[1] $100,000
September 30, 1968	$300,000	100,000	....	400,000	[2] 250,000
January 15, 1969	480,000	60,000	....	540,000	[3] 360,000
November 11, 1969	600,000	200,000	....	800,000	[4] 600,000

[1] $100,000=(the amount in column (2)).
[2] $250,000=([$100,000/$200,000×$300,000]+$100,000).
[3] $360,000=([$250,000/$400,000×$480,000]+$60,000).
[4] $600,000=([$360,000/$540,000×$600,000]+$200,000).

(b) On September 30, 1970, the trustees decide to separate the property of X fund from the other property. The fair market value of all the commingled property is $1 million on September 30, 1970, and there were no additional transfers to the fund after November 11, 1969. Accordingly, the fair market value of the property required to be allocated to X fund must be $750,000 ($600,000/ $800,000×$1,000,000), and X fund's percentage share of the commingled property is 75 percent ($750,000/$1,000,000). Accordingly, assuming that the commingled property consists of Y stock with a fair market value of $800,000 and Z bonds with a fair market value of $200,000, there must be allocated to X fund at the close of September 30, 1970, Y stock with a value of $600,000 ($800,000×75%) and Z bonds with a value of $150,000 ($200,000×75%).

(d) *Transactions before amendment of or severance from fund.* (1) A fund which is amended pursuant to paragraph (c) of this section, or is severed from a fund pursuant to paragraph (a)(2) of this section, shall be treated for all purposes, including the allowance of a deduction for any charitable contribution, as if it were before its amendment or severance a pooled income fund to which section 642(c)(5) and § 1.642(c)–5 apply. Thus, for example, where a donor transferred property in trust to such an amended or severed fund on August 1, 1969, but before its amendment or severance under this section, a charitable contributions deduction for the value of the remainder interest may be allowed under section 170, 2055, 2106, or 2522. The deduction may not be allowed, however, until the fund is amended or severed pursuant to this section and shall be allowed only if a claim for credit or refund is filed within the period of limitation prescribed by section 6511(a).

(2) For purposes of determining under § 1.642(c)–6 the highest yearly rate of return earned by a fund (which is amended pursuant to paragraph (c) of this section) for the 3 preceding taxable years, taxable years of the fund preceding its taxable year in which the fund is so amended and qualifies as a pooled income fund under this section shall be used provided that the fund did not at any time during such preceding years hold any investments in securities the income from which is exempt from tax under subtitle A of the Code. If any such tax-exempt securities were held during such period by such amended fund, or if the fund consists of a portion of a fund which is severed pursuant to paragraph (a)(2) of this section, the highest yearly rate of return under § 1.642(c)–6 shall be determined by treating the fund as a pooled income fund which has been in existence for less than 3 taxable years preceding the taxable year in which the transfer of property to the fund is made.

(3) Property transferred to a fund before its amendment pursuant to paragraph (c) of this section, or before its severance under paragraph (a)(2) of this section, shall be treated as property received from transfers which meet the requirements of section 642(c)(5).

[T.D. 7105, 36 FR 6486, Apr. 6, 1971, as amended by T.D. 7125, 36 FR 11032, June 8, 1971; T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.642(d)–1 Net operating loss deduction.

The net operating loss deduction allowed by section 172 is available to estates and trusts generally, with the following exceptions and limitations:

(a) In computing gross income and deductions for the purposes of section 172, a trust shall exclude that portion of the income and deductions attributable to the grantor or another person under sections 671 through 678 (relating to grantors and others treated as substantial owners).

(b) An estate or trust shall not, for the purposes of section 172, avail itself of the deductions allowed by section 642(c) (relating to charitable contributions deductions) and sections 651 and 661 (relating to deductions for distributions).

§ 1.642(e)–1 Depreciation and depletion.

An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term *beneficiaries* includes charitable beneficiaries. See the regulations under those sections.

[T.D. 6712, 29 FR 3655, Mar. 24, 1964]

§ 1.642(f)–1 Amortization deductions.

An estate or trust is allowed amortization deductions with respect to an emergency facility as defined in section 168(d), with respect to a certified pollution control facility as defined in section 169(d), with respect to qualified railroad rolling stock as defined in section 184(d), with respect to certified coal mine safety equipment as defined in section 187(d), with respect to on-the-job training and child-care facilities as defined in section 188(b), and with respect to certain rehabilitations of certified historic structures as defined in section 191, in the same manner and to the same extent as in the case of an individual. However, the principles governing the apportionment of the deductions for depreciation and depletion between fiduciaries and the beneficiaries of an estate or trust (see sections 167(h) and 611(b) and the regulations thereunder) shall be applicable with respect to such amortization deductions.

[T.D. 7700, 45 FR 38055, June 6, 1980]

§ 1.642(g)–1 Disallowance of double deductions; in general.

Amounts allowable under section 2053(a)(2) (relating to administration expenses) or under section 2054 (relating to losses during administration) as deductions in computing the taxable estate of a decedent are not allowed as deductions in computing the taxable income of the estate unless there is filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived. The statement should be filed with the return for the year for which the items are claimed as deductions or with the district director for the internal revenue district in which the return was filed, for association with the return. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed. However, after a statement is filed under section 642(g) with respect to a particular item or portion of an item, the item cannot thereafter be allowed as a deduction for estate tax purposes since the waiver operates as a relinquishment of the right to have the deduction allowed at any time under section 2053 or 2054.

§ 1.642(g)–2 Deductions included.

It is not required that the total deductions, or the total amount of any deduction, to which section 642(g) is applicable be treated in the same way. One deduction or portion of a deduction may be allowed for income tax purposes if the appropriate statement is filed, while another deduction or portion is allowed for estate tax purposes. Section 642(g) has no application to deductions for taxes, interest, business expenses, and other items accrued at the date of a decedent's death so that they are allowable as a deduction under section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowable under section 691(b) as deductions in respect of a decedent for income tax purposes. However, section 642(g) is applicable to deductions for interest, business expenses, and other items not accrued at the date of the decedent's death so that they are allowable as deductions for estate tax purposes only as administration expenses under section 2053(a)(2). Although deductible under section 2053(a)(3) in determining the value of the taxable estate of a decedent, medical, dental, etc., expenses of a decedent which are paid by the estate of the decedent are not deductible in computing the taxable income of the estate. See section 213(d) and the regulations thereunder for rules relating to the deductibility of such expenses in computing the taxable income of the decedent.

§ 1.642(h)–1 Unused loss carryovers on termination of an estate or trust.

(a) If, on the final termination of an estate or trust, a net operating loss carryover under section 172 or a capital loss carryover under section 1212 would be allowable to the estate or trust in a taxable year subsequent to the taxable year of termination but for the termination, the carryover or carryovers are allowed under section 642(h)(1) to the beneficiaries succeeding to the property of the estate or trust. See § 1.641(b)–3 for the determination of when an estate or trust terminates.

(b) The net operating loss carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust, except that the capital loss carryover in the hands of a beneficiary which is a corporation is a short-term loss irrespective of whether it would have been a long-term or short-term capital loss in the hands of the estate or trust. The net operating loss carryover and the capital loss carryover are taken into account in computing taxable income, adjusted gross income, and the tax imposed by section 56 (relating to the minimum tax for tax preferences). The first taxable year of the beneficiary to which the loss shall be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates. However, for purposes of determining the number of years to which a net operating loss, or a capital loss under paragraph (a) of § 1.1212–1, may be carried over by a beneficiary, the last taxable year of the estate or trust (whether or not a short taxable year) and the first taxable year of the beneficiary to which a loss is carried over each constitute a taxable year, and, in the case of a beneficiary of an estate or trust that is a corporation, capital losses carried over by the estate or trust to any taxable year of the estate or trust beginning after December 31, 1963, shall be treated as if they were incurred in the last taxable year of the estate or trust (whether or not a short taxable year). For the treatment of the net operating loss carryover when the last taxable year of the estate or trust is the last taxable year to which such loss can be carried over, see § 1.642(h)–2.

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

Example 1. A trust distributes all of its assets to A, the sole remainderman, and terminates on December 31, 1954, when it has a capital loss carryover of $10,000 attributable to transactions during the taxable year 1952. A, who reports on the calendar year basis, otherwise has ordinary income of $10,000 and capital gains of $4,000 for the taxable year 1954. A would offset his capital gains of $4,000 against the capital loss of the trust and, in addition, deduct under section 1211(b) $1,000 on his return for the taxable year 1954. The balance of the capital loss carryover of $5,000 may be carried over only to the years 1955 and 1956, in accordance with paragraph (a) of § 1.1212–1 and the rules of this section.

Example 2. A trust distributes all of its assets, one-half to A, an individual, and one-half to X, a corporation, who are the sole remaindermen, and terminates on December 31, 1966, when it has a short-term capital loss carryover of $20,000 attributable to short-term transactions during the taxable years 1964, 1965, and 1966, and a long-term capital loss carryover of $12,000 attributable to long-term transactions during such years. A, who reports on the calendar year basis, otherwise has ordinary income of $15,000, short-term capital gains of $4,000 and long-term capital gains of $6,000, for the taxable year 1966. A would offset his short-term capital gains of $4,000 against his share of the short-term capital loss carryover of the trust, $10,000 (one-half of $20,000), and, in addition deduct under section 1211(b) $1,000 (treated as a short-term gain for purposes of computing capital loss carryovers) on his return for the taxable year 1966. A would also offset his long-term capital gains of $6,000 against his share of the long-term capital loss carryover of the trust, $6,000 (one-half of $12,000). The balance of A's share of the short-term capital loss carryover, $5,000, may be carried over as a short-term capital loss carryover to the succeeding taxable year and treated as a short-term capital loss incurred in such succeeding taxable year in accordance with paragraph (b) of § 1.1212–1. X, which also reports on the calendar year basis, otherwise has capital gains of $4,000 for the taxable year 1966. X would offset its capital gains of $4,000 against its share of the capital loss carryovers of the trust, $16,000 (the sum of one-half of each the short-term carryover and the long-term carryover of the trust), on its return for the taxable year 1966. The balance of X's share, $12,000, may be carried over as a short-term capital loss only to the years 1967, 1968, 1969, and 1970, in accordance with paragraph (a) of § 1.1212–1 and the rules of this section.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7805, June 17, 1965; T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.642(h)–2 Excess deductions on termination of an estate or trust.

(a) If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction to the beneficiaries succeeding to the property of the estate or trust. The deduction is allowed only in computing taxable income and must be taken into account in computing the items of tax preference of the beneficiary; it is not allowed in computing adjusted gross income. The deduction is allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year. For example: Assume that a trust distributes all of its assets to B and terminates on December 31, 1954. As of that date it has excess deductions, for example, because of corpus commissions on termination, of $18,000. B, who reported on the calendar year basis, could claim the $18,000 as a deduction for the taxable year 1954. However, if the deduction (when added to his other deductions) exceeds his gross income, the excess may not be carried over to the year 1955 or subsequent years.

(b) A deduction based upon a net operating loss carryover will never be allowed to beneficiaries under both paragraphs (1) and (2) of section 642(h). Accordingly, a net operating loss deduction which is allowable to beneficiaries succeeding to the property of the estate or trust under the provisions of paragraph (1) of section 642(h) cannot also be considered a deduction for purposes of paragraph (2) of section 642(h) and paragraph (a) of this section. However, if the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction, to the extent not absorbed in that taxable year by the estate or trust, is considered an ''excess deduction'' under section 642(h)(2) and paragraph (a) of this section.

(c) Any item of income or deduction, or any part thereof, which is taken into account in determining the net operating loss or capital loss carryover of the estate or trust for its last taxable year shall not be taken into account again in determining excess deductions on termination of the trust or estate within the meaning of section 642(h)(2) and paragraph (a) of this section (see example in §1.642(h)–5).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.642(h)–3 Meaning of "beneficiaries succeeding to the property of the estate or trust".

(a) The phrase *beneficiaries succeeding to the property of the estate or trust* means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h).

(b) With reference to an intestate estate, the phrase means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it had not been insolvent. If a decedent's spouse is entitled to a specified dollar amount of property before any distribution to other heirs and next of kin, and if the estate is less than that amount, the spouse is the beneficiary succeeding to the property of the estate or trust to the extent of the deficiency in amount.

(c) In the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it is not payable in full. On the other hand, the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question. Thus the phrase includes:

(1) A beneficiary of a fraction of a decedent's net estate after payment of debts, expenses, etc.;

(2) A nonresiduary legatee or devisee, to the extent of any deficiency in his legacy or devise resulting from the insufficiency of the estate to satisfy it in full;

(3) A surviving spouse receiving a fractional share of an estate in fee under a statutory right of election, to the extent that the loss or deductions are taken into account in determining the share. However, the phrase does not include a recipient of dower or curtesy, or any income beneficiary of the estate or trust from which the loss or excess deduction is carried over.

(d) The principles discussed in paragraph (c) of this section are equally applicable to trust beneficiaries. A remainderman who receives all or a fractional share of the property of a trust as a result of the final termination of the trust is a beneficiary succeeding to the property of the trust. For example, if property is transferred to pay the income to A for life and then to pay $10,000 to B and distribute the balance of the trust corpus to C, C and not B is considered to be the succeeding beneficiary except to the extent that the trust corpus is insufficient to pay B $10,000.

§ 1.642(h)–4 Allocation.

The carryovers and excess deductions to which section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust (see §1.642(h)–3) proportionately according to the share of each in the burden of the loss or deductions. A person who qualified as a beneficiary succeeding to the property of an estate or trust with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate or trust as to the amount with respect to which he qualifies. The application of this section may be illustrated by the following example:

Example. A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

§ 1.642(h)–5 Example.

The application of section 642(h) may be illustrated by the following example:

Example. (a) A decedent dies January 31, 1954, leaving a will which provides for distributing all her estate equally to A and an existing trust for B. The period of administration of the estate terminates on December 31, 1954, at which time all the property of the estate is distributed to A and the trust. A reports his income for tax purposes on a calendar year basis, and the trust reports its income on the basis of a fiscal year ending August 31. During the period of the administration, the estate has the following items of income and deductions:

Taxable interest	$2,500
Business income	3,000
Total	5,500
Business expenses (including administrative expense allocable to business income)	5,000
Administrative expenses and corpus commissions not allocable to business income	9,800
Total deductions	14,800

It also has a capital loss of $5,000.

(b) Under section 642(h)(1), an unused net operating loss carryover of the estate on termination of $2,000 will be allowable to: A to the extent of $1,000 for his taxable year 1954 and the next four taxable years in accordance with section 172; and to the trust to the extent of $1,000 for its taxable year ending August 31, 1955, and its next four taxable years. The amount of the net operating loss carryover is computed as follows:

Deductions of estate for 1954	$14,800	
Less adjustment under section 172(d)(4) (deductions not attributable to a trade or business ($9,800) allowable only to extent of gross income not derived from such trade or business ($2,500))	7,300	
Deductions as adjusted	7,500	
Gross income of estate for 1954	5,500	
Net operating loss of estate for 1954	2,000	
(No deduction for capital loss of $5,000 under section 172(d)(2))		

Neither A nor the trust will be allowed to carry back any part of the net operating loss made available to them under section 642(h)(1).

(c) Under section 642(h)(2), excess deductions of the estate of $7,300 will be allowed as a deduction to A to the extent of $3,650 for the calendar year 1954 and to the trust to the extent of $3,650 for the taxable year ending August 31, 1955. The deduction of $7,300 for administrative expenses and corpus commissions is the only amount which was not taken into account in determining the net operating loss of the estate ($9,800 of such expenses less $2,500 taken into account).

(d) Under section 642(h)(1), there will be allowable to A a capital loss carryover of $2,500 for his taxable year 1954 and for his next 4 taxable years in accordance with paragraph (a) of § 1.1212–1. There will be allowable to the trust a similar capital loss carryover of $2,500 for its taxable year ending August 31, 1955, and its next 4 taxable years (but see paragraph (b) of § 1.643(a)–3), (for taxable years beginning after December 31, 1963, net capital losses may be carried over indefinitely by beneficiaries other than corporations, in accordance with § 1.642(h)–1 and paragraph (b) of § 1.1212–1.)

(e) The carryovers and excess deductions are not allowable directly to B, the trust beneficiary, but to the extent the distributable net income of the trust is reduced by the carryovers and excess deductions B may receive indirect benefit.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7806, June 17, 1965]

§ 1.642(i)–1 Certain distributions by cemetery perpetual care funds.

(a) *In general.* Section 642 (i) provides that amounts distributed during taxable years ending after December 31, 1963, by a cemetery perpetual care fund trust for the care and maintenance of gravesites shall be treated as distributions solely for purposes of sections 651 and 661. The deduction for such a distribution is allowable only if the fund is taxable as a trust. In addition, the fund must have been created pursuant to local law by a taxable cemetery corporation (as defined in § 1.642 (i)–2 (a)) expressly for the care and maintenance of cemetery property. A care fund will be treated as having been created by a taxable cemetery corporation (''cemetery'') if the distributee cemetery is taxable, even though the care fund was created by the distributee cemetery in a year that it was tax-exempt or by a predecessor of such distributee cemetery which was tax-exempt in the year the fund was established. The deduction is the amount of the distributions during the fund's taxable year to the cemetery corporation for such care and maintenance that would be otherwise allowable under section 651 or 661, but in no event is to exceed the limitations described in paragraphs (b) and (c) of this section. The provisions of this paragraph shall not have the effect of extending the period of limitations under section 6511.

(b) *Limitation on amount of deduction.* The deduction in any taxable year may not exceed the product of $5 multiplied by the aggregate number of gravesites sold by the cemetery corporation before the beginning of the taxable year of the trust. In general, the aggregate number of gravesites sold shall be the aggregate number of interment rights sold by the cemetery corporation (including gravesites sold by the cemetery before a care fund trust law was enacted). In addition, the number of gravesites sold shall include gravesites used to make welfare burials. Welfare burials and pre-trust fund law gravesites shall be included only to the extent that the cemetery cares for and maintain such gravesites. For purposes of this section, a gravesite is sold as of the date on which the purchaser acquires interment rights enforceable under local law. The aggregate number of gravesites includes only those gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance.

(c) *Requirements for deductibility of distributions for care and maintenance*—(1) *Obligation for care and maintenance.* A deduction is allowed only for distributions for the care and maintenance of gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance. Such obligation may be established by the trust instrument, by local law, or by the cemetery's practice of caring for and maintaining gravesites, such as welfare burial plots or gravesites sold before the enactment of a care fund trust law.

(2) *Distribution actually used for care and maintenance.* The amount of a deduction otherwise allowable for care fund distributions in any taxable year shall not exceed the portion of such distributions expended by the distributee cemetery corporation for the care and maintenance of gravesites before the end of the fund's taxable year following the taxable year in which it makes the distributions. A 6-month extension of time for filing the trust's return may be obtained upon request under section 6081. The failure of a cemetery to expend the care fund's distributions within a reasonable time before the due date for filing the return will be considered reasonable grounds for granting a 6-month extension of time for section 6081. For purposes of this paragraph, any amount expended by the care fund directly for the care and maintenance of gravesites shall be treated as an additional care fund distribution which is expended on the day of distribution by the cemetery corporation. The fund shall be allowed a deduction for such direct expenditure in the fund's taxable year during which the expenditure is made.

(3) *Example.* The application of paragraph (c)(2) of this section is illustrated by the following example:

A, a calendar-year perpetual care fund trust, meeting the requirements of section 642 (i), makes a $10,000 distribution on December 1, 1978 to X, a taxable cemetery corporation operating on a May 31 fiscal year. From this $10,000 distribution, the cemetery makes the following expenditures for the care and maintenance of gravesites: $2,000 on December 20, 1978; $4,000 on June 1, 1979; $2,000 on October 1, 1979; and $1,000 on April 1, 1980. In addition, as authorized by the trust instrument, A itself makes a direct $1,000 payment to a contractor on September 1, 1979 for qualifying care and maintenance work performed. As a result of these transactions, A will be allowed an $8,000 deduction for its 1978 taxable year attributable to the cemetery's expenditures, and a $1,000 deduction for its 1979 taxable year attributable to the fund's direct payment. A will not be allowed a deduction for its 1978 taxable year for the cemetery's expenditure of either the $1,000 expended on April 1, 1980 or the remaining unspent portion of the original $10,000 distribution. The trustee may request a 6-month extension in order to allow the fund until October 15, 1979 to file its return for 1978.

(d) *Certified statement made by cemetery officials to fund trustees.* A trustee of a cemetery perpetual care fund shall not be held personally liable for civil or criminal penalties resulting from false statements on the trust's tax return to the extent that such false statements resulted from the trustee's reliance on a certified statement made by the cemetery specifying the number of interments sold by the cemetery or the amount of the cemetery's expenditures for care and maintenance. The statement must indicate the basis upon which the cemetery determined what portion of its expenditures were made for the care and maintenance of gravesites. The statement must be certified by an officer or employee of the cemetery who has the responsibility to make or account for expenditures for care and maintenance. A copy of this statement shall be retained by the trustee along with the trust's return and shall be made available for inspection upon request by the Secretary. This paragraph does not relieve the care fund trust of its liability to pay the proper amount of tax due and to maintain adequate records to substantiate each of its deductions, including the deduction provided in section 642(i) and this section.

[T.D. 7651, 44 FR 61596, Oct. 26, 1979]

§ 1.642(i)–2 Definitions.

(a) *Taxable cemetery corporation.* For purposes of section 642(i) and this section, the meaning of the term *taxable cemetery corporation* is limited to a corporation (within the meaning of section 7701(a)(3)) engaged in the business of owning and operating a cemetery that either (1) is not exempt from Federal tax, or (2) is subject to tax under section 511 with respect to its cemetery activities.

(b) *Pursuant to local law.* A cemetery perpetual care fund is created pursuant to local law if:

(1) The governing law of the relevant jurisdiction (State, district, county, parish, etc.) requires or expressly permits the creation of such a fund, or

(2) The legally enforceable bylaws or contracts of a taxable cemetery corporation require a perpetual care fund.

(c) *Gravesite.* A gravesite is any type of interment right that has been sold by a cemetery, including, but not limited to, a burial lot, mausoleum, lawn crypt, niche, or scattering ground. For purposes of § 1.642 (i)–1, the term *gravesites* includes only those gravesites with respect to which the care fund or cemetery has an obligation for care and maintenance within the meaning of § 1.642 (i)–1(c)(1).

(d) *Care and maintenance.* For purposes of section 642(i) and this section, the term *care and maintenance of gravesite* shall be generally defined in accordance with the definition of such term under the local law pursuant to which the cemetery perpetual care fund is created. If the applicable local law contains no definition, care and maintenance of gravesites may include the upkeep, repair and preservation of those portions of cemetery property in which gravesites (as defined in paragraph (c) of this section) have been sold; including gardening, road maintenance, water line and drain repair and other activities reasonably necessary to the preservation of cemetery property. The costs for care and maintenance include, but are not limited to, expenditures for the maintenance, repair and replacement of machinery, tools, and equipment, compensation of employees performing such work, insurance premiums, reasonable payments for employees' pension and other benefit plans, and the costs of maintaining necessary records of lot ownership, transfers and burials. However, if some of the expenditures of the cemetery corporation, such as officers' salaries, are for both care and maintenance and for other purposes, the expenditures must be properly allocated between care and maintenance of gravesites and the other purposes. Only those expenditures that are properly allocable to those portions of cemetery property in which gravesites have been sold qualify as expenditures for care and maintenance of gravesites.

[T.D. 7651, 44 FR 61596, Oct. 26, 1979]

§ 1.643(a)–0 Distributable net income; deduction for distributions; in general.

The term *distributable net income* has no application except in the taxation of estates and trusts and their beneficiaries. It limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income. It is also used to determine the character of distributions to the beneficiaries. Distributable net income means for any taxable year, the taxable income (as defined in section 63) of the estate or trust, computed with the modifications set forth in §§ 1.643(a)–1 through 1.643(a)–7.

§ 1.643(a)–1 Deduction for distributions.

The deduction allowable to a trust under section 651 and to an estate or trust under section 661 for amounts paid, credited, or required to be distributed to beneficiaries is not allowed in the computation of distributable net income.

§ 1.643(a)–2 Deduction for personal exemption.

The deduction for personal exemption under section 642(b) is not allowed in the computation of distributable net income.

§ 1.643(a)–3 Capital gains and losses.

(a) *In general.* Except as provided in § 1.643(a)–6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) *Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)–3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

(c) *Charitable contributions included in distributable net income.* If capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(d) *Capital losses.* Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

(e) *Examples.* The following examples illustrate the rules of this section:

Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2. The facts are the same as in *Example 1*, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example 3. The facts are the same as in *Example 1*, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

Example 4. The facts are the same as in *Example 1*, except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 5. The facts are the same as in *Example 1*, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 6. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Example 7. Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in distributable net income. See §1.641(b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

Example 8. The facts are the same as *Example 7*, except Trustee is directed to pay B $10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.

Example 9. The facts are the same as *Example 7*, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of $1,000,000 and an adjusted basis of $300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.

Example 10. The facts are the same as *Example 9*, except when A reaches 35, Trustee sells all the stock and distributes one-half of the sales proceeds to A. If authorized by the governing instrument and applicable state statute, Trustee may determine to what extent the capital gain is distributed to A. The $500,000 distribution to A may be treated as including a minimum of $200,000 of capital gain (and all of the principal amount of $300,000) and a maximum of $500,000 of the capital gain (with no principal). Trustee evidences the treatment by including the appropriate amount of capital gain in distributable net income on Trust's federal income tax return. If Trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to A, one-half of the capital gain attributable to the sale is included in distributable net income.

Example 11. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12. The facts are the same as in *Example 11,* except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example 13. The facts are the same as in *Example 11,* except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

Example 14. Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. With respect to some trusts, Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee intends to follow a regular practice of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

(f) *Effective date.* This section applies for taxable years of trusts and estates ending after January 2, 2004.

[T.D. 9102, 69 FR 18, Jan. 2, 2004]

§ 1.643(a)–4 Extraordinary dividends and taxable stock dividends.

In the case solely of a trust which qualifies under subpart B (section 651 and following) as a ''simple trust,'' there are excluded from distributable net income extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary in good faith determines that under the terms of the governing instrument and applicable local law such dividends are allocable to corpus. See section 665(e), paragraph (b) of § 1.665(e)–1, and paragraph (b) of § 1.665(e)–1A for the treatment of such dividends upon subsequent distribution.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.643(a)–5 Tax-exempt interest.

(a) There is included in distributable net income any tax-exempt interest excluded from gross income under section 103, reduced by disbursements allocable to such interest which would have been deductible under section 212 but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income).

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)–6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions control. In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see examples 1 and 2 of § 1.662(b)–2 and paragraph (e) of § 1.662(c)–4.

§ 1.643(a)–6 Income of foreign trust.

(a) *Distributable net income of a foreign trust.* In the case of a foreign trust (see section 7701(a)(31)), the determination of distributable net income is subject to the following rules:

(1) There is included in distributable net income the amounts of gross income from sources without the United States, reduced by disbursements allocable to such foreign income which would have been deductible but for the provisions of section 265 (relating to disallowance of deductions allocable to tax exempt income). See paragraph (b) of § 1.643(a)–5 for rules applicable when an estate or trust is allowed a charitable contributions deduction under section 642(c).

(2) In the case of a distribution made by a trust before January 1, 1963, for purposes of determining the distributable net income of the trust for the taxable year in which the distribution is made, or for any prior taxable year;

(i) Gross income from sources within the United States is determined by taking into account the provisions of section 894 (relating to income exempt under treaty); and

(ii) Distributable net income is determined by taking into account the provisions of section 643(a)(3) (relating to exclusion of certain gains from the sale or exchange of capital assets).

(3) In the case of a distribution made by a trust after December 31, 1962, for purposes of determining the distributable net income of the trust for any taxable year, whether ending before January 1, 1963, or after December 31, 1962;

(i) Gross income (for the entire foreign trust) from sources within the United States is determined without regard to the provisions of section 894 (relating to income exempt under treaty);

(ii) In respect of a foreign trust created by a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and § 1.643(d)–1), there shall be included in gross income gains from the sale or exchange of capital assets reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and the deduction under section 1202 (relating to deduction for capital gains) shall not be taken into account; and

(iii) In respect of a foreign trust created by a person other than a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and § 1.643(d)–1), distributable net income is determined by taking into account all of the provisions of section 643 except section 643(a)(6)(C) (relating to gains from the sale or exchange of capital assets by a foreign trust created by a U.S. person).

(b) *Examples.* The application of this section, showing the computation of distributable net income for one of the taxable years for which such a computation must be made, may be illustrated by the following examples:

Example 1. (1) A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The income from the trust corpus is to be accumulated until the beneficiary, a resident citizen of the United States who was born in 1944, reaches the age of 21 years, and upon his reaching that age, the corpus and accumulated income are to be distributed to him. The trust instrument provides that capital gains are to be allocated to corpus and are not to be paid, credited, or required to be distributed to any beneficiary during the taxable year or paid, permanently set aside, or to be used for the purposes specified in section 642(c). Under the terms of a tax convention between the United States and Country X, interest income received by the trust from U.S. sources is exempt from U.S. taxation. In 1965 the corpus and accumulated income are distributed to the beneficiary. During the taxable year 1964, the trust has the following items of income, loss, and expense:

Interest on bonds of a U.S. corporation	$10,000
Net long-term capital gain from U.S. sources	30,000
Gross income from investments in Country X	40,000
Net short-term capital loss from U.S. sources	5,000
Expenses allocable to gross income from investments in Country X	5,000

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is $70,000, computed as follows:

Interest on bonds of a U.S. corporation		$10,000
Gross income from investments in Country X		40,000
Net long-term capital gain from U.S. sources	$30,000	
Less: Net short-term capital loss from U.S. sources	5,000	
Excess of net long-term capital gain over net short-term capital loss		25,000
Total		75,000
Less: Expenses allocable to income from investments in Country X		5,000
Distributable net income		70,000

(3) In determining the distributable net income of $70,000, the taxable income of the trust is computed with the following modifications: No deduction is allowed for the personal exemption of the trust (section 643(a)(2)); the interest received on bonds of a U.S. corporation is included in the trust gross income despite the fact that such interest is exempt from U.S. tax under the provisions of the tax treaty between Country X and the United States (section 643(a)(6) (see H. Con. Res. (B)); the excess of net long-term capital gain over net short-term capital loss allocable to corpus is included in distributable net income, but such excess is not subject to the deduction under section 1202 (section 643(a)(6)(C)); and the amount representing gross income from investments in Country X is included, but such amount is reduced by the amount of the disbursements allocable to such income (section 643(a)(6)(A)).

Example 2. (1) The facts are the same as in example 1 except that money or property has also been transferred to the trust by a person other than a U.S. person and, pursuant to the provisions of § 1.643(d)–1, during 1964 only 60 percent of the entire trust constitutes a foreign trust created by a U.S. person.

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is $42,000 computed as follows:

Interest on bonds of a U.S. corporation (60 percent of $10,000)		$6,000
Gross income from investments in Country X (60 percent of $40,000)		24,000
Net long-term capital gain from U.S. sources (60 percent of $30,000)	$18,000	
Less: Net short-term capital loss from U.S. sources (60 percent of $5,000)	3,000	
		15,000
Total		45,000
Less: Expenses allocable to income from investments in Country X (60 percent of $5,000)		3,000
Distributable net income		42,000

(3) The distributable net income for the taxable year 1964 of the portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person, determined under section 643(a), is $18,000, computed as follows:

Interest on bonds of a U.S. corporation (40 percent of $10,000)	$4,000
Gross income from investments in Country X (40 percent of $40,000)	16,000
Total	20,000
Less: Expenses allocable to income from investments in Country X (40 percent of $5,000)	2,000
Distributable net income	18,000

(4) The distributable net income of the entire foreign trust for the taxable year 1964 is $60,000, computed as follows:

Distributable net income of the foreign trust created by a U.S. person	$42,000
Distributable net income of that portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person	18,000
Distributable net income of the entire foreign trust	60,000

It should be noted that the difference between the $70,000 distributable net income of the foreign trust in example 1 and the $60,000 distributable net income of the entire foreign trust in this example is due to the $10,000 (40 percent of $25,000) net capital gain (capital gain net income for taxable years beginning after December 31, 1976) which under section 643(a)(3) is excluded from the distributable net income of that portion of the foreign trust in example 2 which does not constitute a foreign trust created by a U.S. person.

[T.D. 6989, 34 FR 731, Jan. 17, 1969, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.643(a)–7 Dividends.

Dividends excluded from gross income under section 116 (relating to partial exclusion of dividends received) are included in distributable net income. For this purpose, adjustments similar to those required by § 1.643(a)–5 with respect to expenses allocable to tax-exempt income and to income included in amounts paid or set aside for charitable purposes are not made. See the regulations under section 642(c).

[T.D. 7357, 40 FR 23742, June 2, 1975]

§ 1.643(a)–8 Certain distributions by charitable remainder trusts.

(a) *Purpose and scope.* This section is intended to prevent the avoidance of the purposes of the charitable remainder trust rules regarding the characterizations of distributions from those trusts in the hands of the recipients and should be interpreted in a manner consistent with this purpose. This section applies to all charitable remainder trusts described in section 664 and the beneficiaries of such trusts.

(b) *Deemed sale by trust.* (1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year in which a distribution of an annuity or unitrust amount is made from the trust, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount would (but for the application of this paragraph (b)) be characterized in the hands of the recipient as being from the category described in section 664(b)(4) and exceeds the amount of the previously undistributed

(i) Cash contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); plus

(ii) Basis in any contributed property (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522) that was sold by the trust.

(2) Any transaction that has the purpose or effect of circumventing the rules in this paragraph (b) shall be disregarded.

(3) For purposes of paragraph (b)(1) of this section, trust assets do not include cash or assets purchased with the proceeds of a trust borrowing, forward sale, or similar transaction.

(4) Proper adjustment shall be made to any gain or loss subsequently realized for gain or loss taken into account under paragraph (b)(1) of this section.

(c) *Examples.* The following examples illustrate the rules of paragraph (b) of this section:

Example 1. Deemed sale by trust. Donor contributes stock having a fair market value of $2 million to a charitable remainder unitrust with a unitrust amount of 50 percent of the net fair market value of the trust assets and a two-year term. The stock has a total adjusted basis of $400,000. In Year 1, the trust receives dividend income of $20,000. As of the valuation date, the trust's assets have a net fair market value of $2,020,000 ($2 million in stock, plus $20,000 in cash). To obtain additional cash to pay the unitrust amount to the noncharitable beneficiary, the trustee borrows $990,000 against the value of the stock. The trust then distributes $1,010,000 to the beneficiary before the end of Year 1. Under section 664(b)(1), $20,000 of the distribution is characterized in the hands of the beneficiary as dividend income. The rest of the distribution, $990,000, is attributable to an amount received by the trust that did not represent either cash contributed to the trust or a return of basis in any contributed asset sold by the trust during Year 1. Under paragraph (b)(3) of this section, the stock is a trust asset because it was not purchased with the proceeds of the borrowing. Therefore, in Year 1, under paragraph (b)(1) of this section, the trust is treated as having sold $990,000 of stock and as having realized $792,000 of capital gain (the trust's basis in the shares deemed sold is $198,000). Thus, in the hands of the beneficiary, $792,000 of the distribution is characterized as capital gain under section 664(b)(2) and $198,000 is characterized as a tax-free return of corpus under section 664(b)(4). No part of the $990,000 loan is treated as acquisition indebtedness under section 514(c) because the entire loan has been recharacterized as a deemed sale.

Example 2. Adjustment to trust's basis in assets deemed sold. The facts are the same as in *Example 1.* During Year 2, the trust sells the stock for $2,100,000. The trustee uses a portion of the proceeds of the sale to repay the outstanding loan, plus accrued interest. Under paragraph (b)(4) of this section, the trust's adjusted basis in the stock is $1,192,000 ($400,000 plus the $792,000 of gain recognized in Year 1). Therefore, the trust recognizes capital gain (as described in section 664(b)(2)) in Year 2 of $908,000.

Example 3. Distribution of cash contributions. Upon the death of D, the proceeds of a life insurance policy on D's life are payable to T, a charitable remainder annuity trust. The terms of the trust provide that, for a period of three years commencing upon D's death, the trust shall pay an annuity amount equal to $x annually to A, the child of D. After the expiration of such three-year period, the remainder interest in the trust is to be transferred to charity Z. In Year 1, the trust receives payment of the life insurance proceeds and pays the appropriate pro rata portion of the $x annuity to A from the insurance proceeds. During Year 1, the trust has no income. Because the entire distribution is attributable to a cash contribution (the insurance proceeds) to the trust for which a charitable deduction was allowable under section 2055 with respect to the present value of the remainder interest passing to charity, the trust will not be treated as selling a pro rata portion of the trust assets under paragraph (b)(1) of this section. Thus, the distribution is characterized in A's hands as a tax-free return of corpus under section 664(b)(4).

(d) *Effective date.* This section is applicable to distributions made by a charitable remainder trust after October 18, 1999.

[T.D. 8926, 66 FR 1037, Jan. 5, 2001]

§ 1.643(b)–1 Definition of income.

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, ''income,'' when not preceded by the words ''taxable,'' ''distributable net,'' ''undistributed net,'' or ''gross,'' means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004.

[T.D. 9102, 69 FR 19, Jan. 2, 2004]

§ 1.643(b)–2 Dividends allocated to corpus.

Extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not considered ''income'' for purposes of subpart A, B, C, or D, part I, subchapter J, chapter 1 of the Code. See section 643(a)(4), § 1.643(a)–4, § 1.643(d)–2, section 665(e), paragraph (b) of § 1.665(e)–1, and paragraph (b) of § 1.665(e)–1A for the treatment of such items in the computation of distributable net income.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.643(c)–1 Definition of "beneficiary".

An heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent's will is a beneficiary of the decedent's estate. The following persons are treated as beneficiaries:

(a) Any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)–4.

(b) The grantor of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 677(b) out of corpus or out of other than income for the taxable year of the trust.

(c) The trustee or cotrustee of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 678(c) out of corpus or out of other than income for the taxable year of the trust.

§ 1.643(d)–1 Definition of "foreign trust created by a United States person".

(a) *In general.* For the purpose of part I, subchapter J, chapter 1 of the Internal Revenue Code, the term *foreign trust created by a United States person* means that portion of a foreign trust (as defined in section 7701(a)(31)) attributable to money or property (including all accumulated earnings, profits, or gains attributable to such money or property) of a U.S. person (as defined in section 7701(a)(30)) transferred directly or indirectly, or under the will of a decedent who at the date of his death was a U.S. citizen or resident, to the foreign trust. A foreign trust created by a person who is not a U.S. person, to which a U.S. person transfers his money or property, is a foreign trust created by a U.S. person to the extent that the fair market value of the entire foreign trust is attributable to money or property of the U.S. person transferred to the foreign trust. The transfer of money or property to the foreign trust may be made either directly or indirectly by a U.S. person. Transfers of money or property to a foreign trust do not include transfers of money or property pursuant to a sale or exchange which is made for a full and adequate consideration. Transfers to which section 643(d) and this section apply are transfers of money or property which establish or increase the corpus of a foreign trust. The rules set forth in this section with respect to transfers by a U.S. person to a foreign trust also are applicable with respect to transfers under the will of a decedent who at the date of his death was a U.S. citizen or resident. For provisions relating to the information returns which are required to be filed with respect to the creation of or transfers to foreign trusts, see section 6048 and § 16.3–1 of this chapter (Temporary Regulations under the Revenue Act of 1962).

(b) *Determination of a foreign trust created by a U.S. person*—(1) *Transfers of money or property only by a U.S. person.* If all the items of money or property constituting the corpus of a foreign trust are transferred to the trust by a U.S. person, the entire foreign trust is a foreign trust created by a U.S. person.

(2) *Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers required to be treated as separate funds.* Where there are transfers of money or property by both a U.S. person and a person other than a U.S. person to a foreign trust, and it is necessary, either by reason of the provisions of the governing instrument of the trust or by reason of some other requirement such as local law, that the trustee treat the entire foreign trust as composed of two separate funds, one consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the U.S. person and the other consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the person other than the U.S. person, the foreign trust created by a U.S. person shall be the fund consisting of the money or property transferred by the U.S. person. See example 1 in paragraph (c) of this section.

(3) *Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers not required to be treated as separate funds.* Where the corpus of a foreign trust consists of money or property transferred to the trust (simultaneously or at different times) by a U.S. person and by a person who is not a U.S. person, the foreign trust created by a U.S. person within the meaning of section 643(d) is that portion of the entire foreign trust which, immediately after any transfer of money or property to the trust, the fair market value of money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred to the foreign trust by the U.S. person bears to the fair market value of the corpus (including all accumulated earnings, profits, or gains attributable to the corpus) of the entire foreign trust.

(c) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples. Example 1 illustrates the application of paragraph (b)(2) of this section. Example (2) illustrates the application of paragraph (b)(3) of this section in a case where there is no provision in the governing instrument of the trust or elsewhere which would require the trustee to treat the corpus of the trust as composed of more than one fund.

Example 1. On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it stock of a U.S. corporation with a fair market value of $50,000. On the same day, a person other than a U.S. person transfers to the trust Country X bonds with a fair market value of $25,000. The governing instrument of the trust provides that the income from the stock of the U.S. corporation is to be accumulated until A, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the stock and income accumulated thereon are to be distributed to him. The governing instrument of the trust further provides that the income from the Country X bonds is to be accumulated until B, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the bonds and income accumulated thereon are to be distributed to him. To comply with the provisions of the governing instrument of the trust that the income from the stock of the U.S. corporation be accumulated and distributed to A and that the income from the Country X bonds be accumulated and distributed to B, it is necessary that the trustee treat the transfers as two separate funds. The fund consisting of the stock of the U.S. corporation is a foreign trust created by a U.S. person.

Example 2. On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it property having a fair market value of $60,000 and a person other than a U.S. person transfers to it property having a fair market value of $40,000. Immediately after these transfers, the foreign trust created by a U.S. person is 60 percent of the entire foreign trust, determined as follows:

$60,000 (Value of property transferred by U.S. person)/$100,000 (Value of entire property transferred to trust)=60 percent

The undistributed net income for the calendar years 1964 and 1965 is $20,000 which increases the value of the entire foreign trust to $120,000 ($100,000 plus $20,000). Accordingly, as of December 31, 1965, the portion of the foreign trust created by the U.S. person is $72,000 (60 percent of $120,000). On January 1, 1966, the U.S. person transfers property having a fair market value of $40,000 increasing the value of the entire foreign trust to $160,000 ($120,000 plus $40,000) and increasing the value of the portion of the foreign trust created by the U.S. person to $112,000 ($72,000 plus $40,000). Immediately, after this transfer, the foreign trust created by the U.S. person is 70 percent of the entire foreign trust, determined as follows:

$112,000 (Value of property transferred by U.S. person)/$160,000 (Value of entire property transferred to the trust)=70 percent

[T.D. 6989, 34 FR 732, Jan. 17, 1969]

§ 1.643(d)–2 Illustration of the provisions of section 643.

(a) The provisions of section 643 may be illustrated by the following example:

Example. (1) Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to corpus and all expenses are charges against corpus. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations	$30,000
Extraordinary dividends allocated to corpus by the trustee in good faith	20,000
Taxable interest	10,000
Tax-exempt interest	10,000
Long-term capital gains	10,000
Trustee's commissions and miscellaneous expenses allocable to corpus	5,000

(2) The ''income'' of the trust determined under section 643(b) which is currently distributable to W is $50,000, consisting of dividends of $30,000, taxable interest of $10,000, and tax-exempt interest of $10,000. The trustee's commissions and miscellaneous expenses allocable to tax-exempt interest amount to $1,000 (10,000/50,000× $5,000).

(3) The ''distributable net income'' determined under section 643(a) amounts to $45,000, computed as follows:

Dividends from domestic corporations		$30,000
Taxable interest		10,000
Nontaxable interest	$10,000	
Less: Expenses allocable thereto	1,000	
		9,000
Total		49,000
Less: Expenses ($5,000 less $1,000 allocable to tax-exempt interest)		4,000
Distributable net income		45,000

In determining the distributable net income of $45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust (section 643(a) (1) and (2)); capital gains allocable to corpus are excluded and the deduction allowable under section 1202 is not taken into account (section 643(a)(3)): the extraordinary dividends allocated to corpus by the trustee in good faith are excluded (sections 643(a)(4)); and the tax- exempt interest (as adjusted for expenses) and the dividend exclusion of $50 are included) section 643(a) (5) and (7)).

(b) See paragraph (c) of the example in § 1.661(c)–2 for the computation of distributable net income where there is a charitable contributions deduction.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960. Redesignated, T.D. 6989, 34 FR 732, Jan. 1, 1969]

§ 1.643(h)–1 Distributions by certain foreign trusts through intermediaries.

(a) *In general*—(1) *Principal purpose of tax avoidance.* Except as provided in paragraph (b) of this section, for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, and section 6048, any property (within the meaning of paragraph (f) of this section) that is transferred to a United States person by another person (an intermediary) who has received property from a foreign trust will be treated as property transferred directly by the foreign trust to the United States person if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of United States tax.

(2) *Principal purpose of tax avoidance deemed to exist.* For purposes of paragraph (a)(1) of this section, a transfer will be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of United States tax if the United States person—

(i) Is related (within the meaning of paragraph (e) of this section) to a grantor of the foreign trust, or has another relationship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer (within the meaning of § 1.671–2(e)(2)) to the United States person;

(ii) Receives from the intermediary, within the period beginning twenty-four months before and ending twenty-four months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and

(iii) Cannot demonstrate to the satisfaction of the Commissioner that—

(A) The intermediary has a relationship with the United States person that establishes a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the United States person;

(B) The intermediary acted independently of the grantor and the trustee of the foreign trust;

(C) The intermediary is not an agent of the United States person under generally applicable United States agency principles; and

(D) The United States person timely complied with the reporting requirements of section 6039F, if applicable, if the intermediary is a foreign person.

(b) *Exceptions*—(1) *Nongratuitous transfers.* Paragraph (a) of this section does not apply to the extent that either the transfer from the foreign trust to the intermediary or the transfer from the intermediary to the United States person is a transfer that is not a gratuitous transfer within the meaning of § 1.671–2(e)(2).

(2) *Grantor as intermediary.* Paragraph (a) of this section does not apply if the intermediary is the grantor of the portion of the trust from which the property that is transferred is derived. For the definition of *grantor*, see § 1.671–2(e).

(c) *Effect of disregarding intermediary*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, the intermediary is treated as an agent of the foreign trust, and the property is treated as transferred to the United States person in the year the property is transferred, or made available, by the intermediary to the United States person. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the United States person. For purposes of section 665(d)(2), the term *taxes imposed on the trust* includes any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred.

(2) *Exception.* If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the United States person under generally applicable United States agency principles, the property will be treated as transferred to the United States person in the year the intermediary receives the property from the foreign trust. The fair market value of the property transferred will be determined as of the date of the transfer by the foreign trust to the intermediary. For purposes of section 901(b), any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred will be treated as having been imposed on the United States person.

(3) *Computation of gross income of intermediary.* If property is treated as transferred directly by the foreign trust to a United States person pursuant to this section, the fair market value of such property is not taken into account in computing the gross income of the intermediary (if otherwise required to be taken into account by the intermediary but for paragraph (a) of this section).

(d) *Transfers not in excess of $10,000.* This section does not apply if, during the taxable year of the United States person, the aggregate fair market value of all property transferred to such person from all foreign trusts either directly or through one or more intermediaries does not exceed $10,000.

(e) *Related parties.* For purposes of this section, a United States person is treated as related to a grantor of a foreign trust if the United States person and the grantor are related for purposes of section 643(i)(2)(B), with the following modifications—

(1) For purposes of applying section 267 (other than section 267(f)) and section 707(b)(1), ''at least 10 percent'' is

used instead of ''more than 50 percent'' each place it appears; and

(2) The principles of section 267(b)(10), using ''at least 10 percent'' instead of ''more than 50 percent,'' apply to determine whether two corporations are related.

(f) *Definition of property.* For purposes of this section, the term *property* includes cash.

(g) *Examples.* The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust that is not treated as owned by any other person and the fair market value of the property that is transferred exceeds $10,000. The examples are as follows:

Example 1. Principal purpose of tax avoidance. FT was created in 1980 by A, a nonresident alien, for the benefit of his children and their descendants. FT's trustee, T, determines that 1000X of accumulated income should be distributed to A's granddaughter, B, who is a resident alien. Pursuant to a plan with a principal purpose of avoiding the interest charge that would be imposed by section 668, T causes FT to make a gratuitous transfer (within the meaning of § 1.671–2(e)(2)) of 1000X to I, a foreign person. I subsequently makes a gratuitous transfer of 1000X to B. Under paragraph (a)(1) of this section, FT is deemed to have made an accumulation distribution of 1000X directly to B.

Example 2. United States person unable to demonstrate that intermediary acted independently. GM and her daughter, M, are both nonresident aliens. M's daughter, D, is a resident alien. GM creates and funds FT for the benefit of her children. On July 1, 2001, FT makes a gratuitous transfer of XYZ stock to M. M immediately sells the XYZ stock and uses the proceeds to purchase ABC stock. On January 1, 2002, M makes a gratuitous transfer of the ABC stock to D. D is unable to demonstrate that M acted independently of GM and the trustee of FT in making the transfer to D. Under paragraph (a)(2) of this section, FT is deemed to have distributed the ABC stock to D. Under paragraph (c)(1) of this section, M is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 3. United States person demonstrates that specified conditions are satisfied. Assume the same facts as in *Example 2*, except that M receives 1000X cash from FT instead of XYZ stock. M gives 1000X cash to D on January 1, 2002. Also assume that M receives annual income of 5000X from her own investments and that M has given D 1000X at the beginning of each year for the past ten years. Based on this and additional information provided by D, D demonstrates to the satisfaction of the Commissioner that M has a relationship with D that establishes a reasonable basis for concluding that M would make a gratuitous transfer to D, that M acted independently of GM and the trustee of FT, that M is not an agent of D under generally applicable United States agency principles, and that D timely complied with the reporting requirements of section 6039F. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to D.

Example 4. Transfer to United States person less than 24 months before transfer to intermediary. Several years ago, A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. A has a close friend, C, who also is a nonresident alien. A's granddaughter, B, is a resident alien. On December 31, 2001, C makes a gratuitous transfer of 1000X to B. On January 15, 2002, FT makes a gratuitous transfer of 1000X to C. B is unable to demonstrate that C has a relationship with B that would establish a reasonable basis for concluding that C would make a gratuitous transfer to B or that C acted independently of A and the trustee of FT in making the transfer to B. Under paragraph (a)(2) of this section, FT is deemed to have distributed 1000X directly to B. Under paragraph (c)(1) of this section, C is treated as an agent of FT, and the distribution is deemed to have been made on December 31, 2001.

Example 5. United States person receives property in substitution for property transferred to intermediary. GM and her son, S, are both nonresident aliens. S's daughter, GD, is a resident alien. GM creates and funds FT for the benefit of her children and their descendants. On July 1, 2001, FT makes a gratuitous transfer of ABC stock with a fair market value of approximately 1000X to S. On January 1, 2002, S makes a gratuitous transfer of DEF stock with a fair market value of approximately 1000X to GD. GD is unable to demonstrate that S acted independently of GM and the trustee of FT in transferring the DEF stock to GD. Under paragraph (a)(2) of this section, FT is deemed to have distributed the DEF stock to GD. Under paragraph (c)(1) of this section, S is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 6. United States person receives indirect loan from foreign trust. Several years ago, A, a nonresident alien, created and funded FT for the benefit of her children and their descendants. A's daughter, B, is a resident alien. B needs funds temporarily while she is starting up her own business. If FT were to loan money directly to B, section 643(i) would apply. FT deposits 500X with FB, a foreign bank, on June 30, 2001. On July 1, 2001, FB loans 400X to B. Repayment of the loan is guaranteed by FT's 500X deposit. B is unable to demonstrate to the satisfaction of the Commissioner that FB has a relationship with B that establishes a reasonable basis for concluding that FB would make a loan to B or that FB acted independently of A and the trustee of FT in making the loan. Under paragraph (a)(2) of this section, FT is deemed to have loaned 400X directly to B on July 1, 2001. Under paragraph (c)(1) of this section, FB is treated as an agent of FT. For the treatment of loans from foreign trusts, see section 643(i).

Example 7. United States person demonstrates that specified conditions are satisfied. GM, a nonresident alien, created and funded FT for the benefit of her children and their descendants. One of GM's children is M, who is a resident alien. During the year 2001, FT makes a gratuitous transfer of 500X to M. M reports the 500X on Form 3520 as a distribution received from a foreign trust. During the year 2002, M makes a gratuitous transfer of 400X to her son, S, who also is a resident alien. M files a Form 709 treating the gratuitous transfer to S as a gift. Based on this and additional information provided by S, S demonstrates to the satisfaction of the Commissioner that M has a relationship with S that establishes a reasonable basis for concluding that M would make a gratuitous transfer to S, that M acted independently of GM and the trustee of FT, and that M is not an agent of S under generally applicable United States agency principles. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to S.M

Example 8. Intermediary as agent of trust; increase in FMV. A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. On December 1, 2001, FT makes a gratuitous transfer of XYZ stock with a fair market value of 85X to B, a nonresident alien. On November 1, 2002, B sells the XYZ stock to a third party in an arm's length transaction for 100X in cash. On November 1, 2002, B makes a gratuitous transfer of 98X to A's grandson, C, a resident alien. C is unable to demonstrate to the satisfaction of the Commissioner that B acted independently of A and the trustee of FT in making the transfer. Under paragraph (a)(2) of this section, FT is deemed to have made a distribution directly to C. Under paragraph (c)(1) of this section, B is treated as an agent of FT, and FT is deemed to have distributed 98X to C on November 1, 2002.

Example 9. Intermediary as agent of United States person; increase in FMV. Assume the same facts as in *Example 8*, except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed 85X to C on December 1, 2001. C must take the gain of 15X into account in the year 2002.

Example 10. Intermediary as agent of trust; decrease in FMV. Assume the same facts as in *Example 8,* except that the value of the XYZ stock on November 1, 2002, is only 80X. Instead of selling the XYZ stock to a third party and transferring cash to C, B transfers the XYZ stock to C in a gratuitous transfer. Under paragraph (c)(1) of this section, FT is deemed to have distributed XYZ stock with a value of 80X to C on November 1, 2002.

Example 11. Intermediary as agent of United States person; decrease in FMV. Assume the same facts as in *Example 10,* except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed XYZ stock with a value of 85X to C on December 1, 2001.

(h) *Effective date.* The rules of this section are applicable to transfers made to United States persons after August 10, 1999.

[T.D. 8831, 64 FR 43272, Aug. 10, 1999, as amended by T.D. 8890, 65 FR 41332, July 5, 2000]

POOLED INCOME FUND ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1999

§ 1.642(c)–6A Valuation of charitable remainder interests for which the valuation date is before May 1, 1999.

(a) *Valuation of charitable remainder interests for which the valuation date is before January 1, 1952.* There was no provision for the qualification of pooled income funds under section 642 until 1969. See § 20.2031–7A(a) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest created before January 1, 1952.

(b) *Valuation of charitable remainder interests for which the valuation date is after December 31, 1951, and before January 1, 1971.* No charitable deduction is allowable for a transfer to a pooled income fund for which the valuation date is after the effective dates of the Tax Reform Act of 1969 unless the pooled income fund meets the requirements of section 642(c)(5). See § 20.2031–7A(b) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest for which the valuation date is after December 31, 1951, and before January 1, 1971.

(c) *Present value of remainder interest in the case of transfers to pooled income funds for which the valuation date is after December 31, 1970, and before December 1, 1983.* For the determination of the present value of a remainder interest in property transferred to a pooled income fund for which the valuation date is after December 31, 1970, and before December 1, 1983, see § 20.2031–7A(c) of this chapter (Estate Tax Regulations) and former § 1.642(c)–6(e) (as contained in the 26 CFR part 1 edition revised as of April 1, 1994).

(d) *Present value of remainder interest dependent on the termination of one life in the case of transfers to pooled income funds made after November 30, 1983, for which the valuation date is before May 1, 1989*—(1) *In general.* For transfers to pooled income funds made after November 30, 1983, for which the valuation date is before May 1, 1989, the present value of the remainder interest at the time of the transfer of property to the fund is determined by computing the present value (at the time of the transfer) of the life income interest in the transferred property (as determined under paragraph (d)(2) of this section) and subtracting that value from the fair market value of the transferred property on the valuation date. The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by use of Table G in paragraph (d)(4) of this section. For purposes of the computation under this section, the age of an individual is to be taken as the age of the individual at the individual's nearest birthday.

(2) *Present value of life income interest.* The present value of the life income interest in property transferred to a pooled income fund shall be computed on the basis of:

(i) Life contingencies determined from the values of *lx* that are set forth in Table LN of § 20.2031–7A(d)(6) of this chapter (Estate Tax Regulations); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. For purposes of this paragraph (d)(2), the yearly rate of return of a pooled income fund is determined as provided in § 1.642(c)–6(c) unless the highest yearly rate of return is deemed to be 9 percent. For purposes of this paragraph (d)(2), the first taxable year of a pooled income fund is considered a taxable year even though the taxable year consists of less than 12 months. However, appropriate adjustments must be made to annualize the rate of return earned by the fund for that period. Where it appears from the facts and circumstances that the highest yearly rate of return for the 3 taxable years immediately preceding the taxable year in which the transfer of property is made has been purposely manipulated to be substantially less than the rate of return that would otherwise be reasonably anticipated with the purpose of obtaining an excessive charitable deduction, that rate of return may not be used. In that case, the highest yearly rate of return of the fund is determined by treating the fund as a pooled income fund that has been in existence for less than 3 preceding taxable years. If a pooled income fund has been in existence less than 3 taxable years immediately preceding the taxable year in which the transfer of property to the fund is made, the highest yearly rate of return is deemed to be 9 percent.

(3) *Computation of value of remainder interest.* The factor which is used in determining the present value of the remainder interest is the factor under the appropriate yearly rate of return in column (2) of Table G opposite the number in column (1) which corresponds to the age of the individual upon whose life the value of the remainder interest is based. If the yearly rate of return is a percentage which is between yearly rates of return for which factors are provided in Table G, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying, by the factor determined under this paragraph (d)(3), the fair market value on the appropriate valuation date. If the yearly rate of return is below 2.2 percent or above 14 percent, see § 1.642(c)–6(b). This paragraph (d)(3) may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers $100,000 to a pooled income fund on January 1, 1985, and retains a life income interest in such property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 9.9 percent. In Table G the figure in column (2) opposite 50 years under 9.8 percent is .15653 and under 10 percent is .15257. The present value of the remainder interest is $15,455, computed as follows:

Factor at 9.8 percent for person aged 50	.15653
Factor at 10 percent for person aged 50 ..	.15257
Difference	.00396

Interpolation adjustment:

$$\frac{9.9\% - 9.8\%}{.2\%} = \frac{x}{.00396}$$

Factor at 9.8 percent for person aged 50	0.15653
Less:	
Interpolation adjustment	.00198
Interpolated factor	.15455
Present value of remainder interest ($100,000×.15455	$15,455

(4) *Actuarial tables.* The following tables shall be used in the application of the provisions of this section.

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	2.2%	2.4%	2.6%	2.8%	3.0%
0	.23930	.21334	.19077	.17113	.15401
1	.22891	.20224	.17903	.15880	.14114
2	.23297	.20610	.18265	.16218	.14429
3	.23744	.21035	.18669	.16600	.14787
4	.24212	.21485	.19098	.17006	.15171
5	.24701	.21955	.19547	.17434	.15577
6	.25207	.22442	.20015	.17880	.16001
7	.25726	.22944	.20497	.18342	.16441
8	.26259	.23461	.20995	.18820	.16898
9	.26809	.23995	.21511	.19315	.17373
10	.27373	.24544	.22043	.19828	.17865
11	.27953	.25110	.22592	.20358	.18375
12	.28546	.25690	.23156	.20904	.18902
13	.29149	.26280	.23731	.21462	.19440
14	.29757	.26877	.24312	.22026	.19986
15	.30368	.27476	.24896	.22593	.20535
16	.30978	.28075	.25481	.23161	.21085
17	.31589	.28676	.26068	.23732	.21637
18	.32204	.29280	.26659	.24306	.22193
19	.32825	.29892	.27257	.24889	.22759
20	.33457	.30514	.27867	.25484	.23336
21	.34099	.31148	.28489	.26092	.23927
22	.34751	.31794	.29124	.26712	.24532
23	.35416	.32452	.29773	.27348	.25152
24	.36096	.33127	.30439	.28002	.25791
25	.36793	.33821	.31124	.28676	.26452
26	.37509	.34535	.31832	.29374	.27136
27	.38244	.35269	.32560	.30093	.27844
28	.38998	.36023	.33311	.30836	.28577
29	.39767	.36795	.34080	.31599	.29330

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	2.2%	2.4%	2.6%	2.8%	3.0%
30	.40553	.37584	.34868	.32382	.30104
31	.41352	.38388	.35672	.33182	.30897
32	.42165	.39208	.36494	.34001	.31710
33	.42993	.40044	.37333	.34839	.32543
34	.43834	.40894	.38188	.35694	.33395
35	.44689	.41760	.39060	.36567	.34266
36	.45556	.42640	.39947	.37458	.35156
37	.46435	.43534	.40850	.38365	.36063
38	.47325	.44440	.41767	.39288	.36987
39	.48226	.45358	.42696	.40225	.37927
40	.49136	.46288	.43640	.41177	.38884
41	.50056	.47228	.44596	.42143	.39856
42	.50988	.48182	.45566	.43125	.40846
43	.51927	.49145	.46547	.44120	.41850
44	.52874	.50118	.47540	.45128	.42869
45	.53828	.51099	.48543	.46146	.43899
46	.54788	.52088	.49554	.47176	.44943
47	.55754	.53083	.50574	.48216	.45998
48	.56726	.54087	.51604	.49267	.47065
49	.57703	.55097	.52642	.50327	.48144
50	.58685	.56114	.53688	.51398	.49234
51	.59670	.57136	.54740	.52476	.50333
52	.60658	.58161	.55798	.53560	.51441
53	.61647	.59189	.56859	.54651	.52556
54	.62635	.60217	.57923	.55744	.53675
55	.63622	.61246	.58987	.56840	.54798
56	.64606	.62273	.60052	.57937	.55923
57	.65589	.63299	.61117	.59037	.57052
58	.66569	.64324	.62181	.60136	.58183
59	.67546	.65347	.63246	.61237	.59316
60	.68521	.66368	.64309	.62338	.60450
61	.69492	.67388	.65372	.63440	.61587
62	.70461	.68406	.66434	.64542	.62726
63	.71425	.69420	.67494	.65643	.63865
64	.72384	.70430	.68550	.66742	.65002
65	.73336	.71434	.69602	.67837	.66137
66	.74281	.72431	.70647	.68926	.67267
67	.75216	.73419	.71684	.70009	.68391
68	.76143	.74399	.72714	.71085	.69509
69	.77060	.75370	.73735	.72153	.70622
70	.77969	.76334	.74750	.73215	.71728
71	.78870	.77290	.75758	.74272	.72830
72	.79764	.78240	.76760	.75323	.73928
73	.80646	.79178	.77751	.76364	.75016
74	.81511	.80099	.78725	.77387	.76086
75	.82353	.80995	.79674	.78386	.77132
76	.83169	.81866	.80596	.79357	.78149
77	.83960	.82710	.81491	.80301	.79139
78	.84727	.83530	.82360	.81218	.80101
79	.85473	.84328	.83207	.82112	.81041
80	.86201	.85106	.84034	.82986	.81960
81	.86905	.85861	.84837	.83835	.82853
82	.87585	.86589	.85612	.84655	.83717
83	.88239	.87291	.86360	.85447	.84552
84	.88873	.87971	.87085	.86216	.85362
85	.89487	.88630	.87789	.86963	.86150
86	.90070	.89258	.88459	.87674	.86901
87	.90609	.89838	.89079	.88332	.87597
88	.91106	.90372	.89650	.88939	.88239
89	.91570	.90872	.90184	.89507	.88839
90	.92014	.91350	.90696	.90051	.89416
91	.92435	.91804	.91182	.90569	.89964
92	.92822	.92222	.91630	.91045	.90469
93	.93170	.92597	.92032	.91474	.90923
94	.93477	.92929	.92387	.91853	.91325
95	.93743	.93216	.92695	.92181	.91673

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	2.2%	2.4%	2.6%	2.8%	3.0%
96	.93967	.93458	.92955	.92458	.91966
97	.94167	.93674	.93186	.92704	.92228
98	.94342	.93863	.93389	.92921	.92457
99	94508	94041	.93580	.93124	.92673
100 ..	.94672	.94218	.93770	.93326	.92887
101 ..	.94819	.94377	.93940	.93508	.93080
102 ..	.94979	.94550	.94125	.93704	.93288
103 ..	.95180	.94766	.94357	.93952	.93550
104 ..	.95377	.94979	.94585	.94194	.93806
105 ..	.95663	.95288	.94916	.94547	.94181
106 ..	.96101	.95762	.95425	.95091	.94760
107 ..	.96688	.96398	.96110	.95824	.95539
108 ..	.97569	.97354	.97141	.96928	.96717
109 ..	.98924	.98828	.98733	.98638	.98544

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	3.2%	3.4%	3.6%	3.8%	4.0%
0	.13908	.12603	.11461	.10461	.09583
1	.12570	.11220	.10036	.08998	.08086
2	.12862	.11489	.10284	.09225	.08293
3	.13198	.11802	.10576	.09496	.08544
4	.13559	.12141	.10893	.09793	.08821
5	.13943	.12503	.11234	.10112	.09121
6	.14345	.12884	.11593	.10451	.09439
7	.14763	.13280	.11968	.10805	.09773
8	.15198	.13694	.12360	.11176	.10125
9	.15652	.14126	.12771	.11567	.10495
10	.16123	.14576	.13200	.11975	.10883
11	.16613	.15045	.13648	.12402	.11290
12	.17119	.15531	.14113	.12847	.11715
13	.17638	.16029	.14591	.13304	.12152
14	.18164	.16535	.15076	.13769	.12597
15	.18693	.17044	.15565	.14238	.13045
16	.19224	.17554	.16055	.14707	.13494
17	.19756	.18066	.16547	.15178	.13945
18	.20294	.18584	.17044	.15655	.14401
19	.20840	.19110	.17550	.16140	.14866
20	.21399	.19650	.18069	.16639	.15344
21	.21972	.20203	.18602	.17152	.15836
22	.22559	.20771	.19151	.17680	.16344
23	.23162	.21356	.19716	.18225	.16869
24	.23784	.21960	.20301	.18791	.17414
25	.24429	.22588	.20910	.19380	.17984
26	.25098	.23240	.21545	.19996	.18581
27	.25792	.23918	.22206	.20639	.19205
28	.26512	.24623	.22894	.21310	.19858
29	.27253	.25350	.23605	.22004	.20534
30	.28016	.26100	.24341	.22724	.21236
31	.28799	.26871	.25097	.23464	.21961
32	.29603	.27664	.25877	.24230	.22710
33	.30428	.28478	.26679	.25018	.23484
34	.31273	.29314	.27504	.25830	.24280
35	.32139	.30172	.28351	.26665	.25102
36	.33024	.31050	.29220	.27523	.25948
37	.33929	.31949	.30111	.28404	.26816
38	.34851	.32867	.31022	.29305	.27707

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	3.2%	3.4%	3.6%	3.8%	4.0%
39	.35791	.33804	.31953	.30228	.28620
40	.36749	.34759	.32904	.31172	.29555
41	.37724	.35733	.33874	.32137	.30512
42	.38717	.36727	.34866	.33124	.31493
43	.39727	.37739	.35877	.34132	.32495
44	.40752	.38768	.36906	.35159	.33518
45	.41791	.39811	.37952	.36204	.34560
46	.42844	.40871	.39014	.37267	.35621
47	.43910	.41944	.40092	.38347	.36701
48	.44990	.43034	.41188	.39446	.37801
49	.46083	.44137	.42299	.40562	.38919
50	.47189	.45256	.43427	.41695	.40056
51	.48306	.46386	.44567	.42844	.41209
52	.49432	.47528	.45721	.44006	.42378
53	.50567	.48679	.46886	.45182	.43562
54	.51708	.49838	.48060	.46367	.44756
55	.52854	.51004	.49242	.47563	.45962
56	.54004	.52175	.50430	.48766	.47177
57	.55159	.53352	.51626	.49978	.48402
58	.56316	.54533	.52827	.51196	.49636
59	.57478	.55719	.54036	.52424	.50879
60	.58643	.56910	.55250	.53658	.52131
61	.59811	.58107	.56471	.54901	.53393
62	.60982	.59307	.57697	.56150	.54662
63	.62155	.60510	.58928	.57405	.55940
64	.63327	.61714	.60161	.58664	.57222
65	.64498	.62918	.61395	.59926	.58508
66	.65666	.64120	.62628	.61188	.59796
67	.66829	.65319	.63859	.62448	.61083
68	.67986	.66512	.65086	.63706	.62370
69	.69139	.67702	.66311	.64963	.63656
70	.70286	.68888	.67533	.66218	.64942
71	.71431	.70073	.68754	.67474	.66231
72	.72572	.71255	.69974	.68730	.67520
73	.73704	.72429	.71188	.69980	.68805
74	.74819	.73586	.72384	.71214	.70075
75	.75909	.74718	.73557	.72424	.71320
76	.76971	.75822	.74700	.73606	.72538
77	.78004	.76897	.75815	.74758	.73726
78	.79010	.77944	.76902	.75883	.74886
79	.79993	.78968	.77965	.76984	.76023
80	.80955	.79971	.79008	.78064	.77140
81	.81891	.80948	.80024	.79118	.78230
82	.82796	.81894	.81009	.80140	.79288
83	.83672	.82810	.81962	.81131	.80314
84	.84525	.83700	82891	.82096	.81314
85	.85352	.84567	.83795	.83037	.82291
86	.86141	.85394	.84659	.83936	.83224
87	.86874	.86162	.85461	.84771	.84092
88	.87549	.86870	.86201	.85542	.84893
89	.88182	.87534	.86895	.86266	.85645
90	.88789	.88171	.87562	86961	.86369
91	.89367	.88779	.88198	.87625	.87059
92	.89900	.89338	.88784	.88237	.87697
93	.90379	.89842	.89312	.88788	.88271
94	.90803	.90288	.89780	.89277	.88781
95	.91171	.90675	.90185	.89701	.89223
96	.91481	.91001	.90527	.90058	.89594
97	.91757	.91291	.90831	.90376	.89926
98	.91999	.91546	.91098	.90655	.90217
99	.92227	.91786	.91349	.90917	.90490
100 ..	.92453	.92023	.91598	.91177	.90761
101 ..	.92656	.92236	.91821	.91410	.91003
102 ..	.92875	.92467	.92063	.91662	.91266
103 ..	.93152	.92758	.92367	.91980	91597
104 ..	.93423	.93042	.92665	.92291	.91920

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	3.2%	3.4%	3.6%	3.8%	4.0%
105 ..	.93818	.93458	.93101	.92747	.92395
106 ..	.94430	.94104	.93779	.93457	.93127
107 ..	95256	.94975	.94696	.94418	.94143
108 ..	.96507	96298	.96090	.95883	.95676
109 ..	.98450	.98356	.98263	.98170	.98077

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	4.2%	4.4%	4.6%	4.8%	5.0%
0	.08811	.08132	.07534	.07006	.06539
1	.07283	.06576	.05952	.05400	.04912
2	.07471	.06746	.06106	.05539	.05037
3	.07704	.06962	.06304	.05722	.05205
4	.07962	.07202	.06528	.05930	.05398
5	.08243	.07464	.06773	.06159	.05612
6	.08542	.07745	.07037	.06406	.05844
7	.08857	.08042	.07316	.06669	.06091
8	.09189	.08355	.07612	.06948	.06354
9	.09540	.08687	.07926	.07245	.06635
10	.09908	.09037	.08258	.07560	.06934
11	.10296	.09406	.08609	.07894	.07251
12	.10701	.09793	.08977	.08245	.07586
13	.11119	.10191	.09358	.08608	.07932
14	.11544	.10597	.09745	.08978	.08285
15	.11972	.11007	.10136	.09350	.08640
16	.12402	.11416	.10527	.09723	.08995
17	.12832	.11827	.10919	.10096	.09351
18	.13268	.12243	.11315	.10474	.09711
19	.13712	.12667	.11720	.10860	.10078
20	.14170	.13105	.12138	.11259	.10459
21	.14642	.13557	.12570	.11671	.10853
22	.15129	.14024	.13017	.12099	.11261
23	.15634	.14508	.13481	.12544	.11687
24	.16159	.15013	.13967	.13009	.12133
25	.16709	.15543	.14477	.13500	.12604
26	.17286	.16101	.15014	.14018	.13103
27	.17891	.16686	.15580	.14564	.13630
28	.18525	.17301	.16175	.15140	.14187
29	.19183	.17940	.16796	.15742	.14770
30	.19867	.18606	.17443	.16370	.15380
31	.20574	.19295	.18114	.17023	.16013
32	.21307	.20010	.18811	.17702	.16674
33	.22064	.20751	.19535	.18407	.17362
34	.22846	.21516	.20283	.19138	.18075
35	.23653	.22307	.21058	.19896	.18816
36	.24484	.23124	.21859	.20681	.19584
37	.25340	.23966	.22685	.21492	.20379
38	.26219	.24831	.23536	.22328	.21199
39	.27120	.25720	.24411	.23188	.22044
40	.28045	.26633	.25311	.24075	.22916
41	.28992	.27569	.26236	.24986	.23814
42	.29965	.28532	.27188	.25926	.24741
43	.30960	.29518	.28163	.26890	.25693
44	.31977	.30527	.29164	.27880	.26671
45	.33013	.31557	.30185	.28892	.27673
46	.34071	.32609	.31230	.29929	.28700
47	.35148	.33681	.32296	.30988	.29750

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	4.2%	4.4%	4.6%	4.8%	5.0%
48	.36246	.34777	.33387	.32072	.30826
49	.37364	.35893	.34499	.33179	.31927
50	.38503	.37030	.35634	.34310	.33053
51	.39659	.38187	.36790	.35462	.34201
52	.40832	.39362	.37965	.36636	.35371
53	.42021	.40554	.39158	.37829	.36562
54	.43222	.41760	.40367	.39039	.37771
55	.44436	.42980	.41591	.40264	.38997
56	.45660	.44212	.42828	.41504	.40239
57	.46897	.45456	.44079	.42760	.41498
58	.48142	.46712	.45342	.44030	.42771
59	.49399	.47980	.46620	.45314	.44062
60	.50666	.49260	.47910	.46613	.45367
61	.51944	.50552	.49214	.47927	.46690
62	.53232	.51856	.50531	.49256	.48028
63	.54529	.53169	.51860	.50598	.49381
64	.55832	.54491	.53198	.51950	.50746
65	.57140	.55819	.54544	.53312	.52121
66	.58451	.57152	.55895	.54681	.53506
67	.59763	.58486	.57251	.56054	.54896
68	.61076	.59823	.58609	.57432	.56292
69	.62390	.61162	.59971	.58816	.57695
70	.63705	.62503	.61337	.60204	.59104
71	.65023	.63849	.62709	.61600	.60522
72	.66344	.65199	.64086	.63003	.61949
73	.67661	.66547	.65463	.64407	.63378
74	.68964	.67882	.66827	.65798	.64796
75	.70243	.69193	.68168	.67168	.66192
76	.71495	.70477	.69482	.68511	.67563
77	.72717	.71731	.70768	.69826	.68905
78	.73912	.72959	.72026	.71114	.70221
79	.75083	.74163	.73262	.72379	.71515
80	.76235	.75348	.74479	.73627	.72792
81	.77360	.76506	.75669	.74848	.74043
82	.78452	.77632	.76827	.76036	.75260
83	.79513	.78725	.77952	.77192	.76446
84	.80547	.79792	.79051	.78322	.77606
85	.81557	.80836	.80126	.79429	.78742
86	.82524	.81835	.81157	.80489	.79832
87	.83423	.82764	.82115	.81477	.80847
88	.84253	.83623	.83002	.82390	.81787
89	.85033	.84430	.83836	.83250	.82672
90	.85784	.85208	.84639	.84079	.83525
91	.86502	.85951	.85408	.84871	.84342
92	.87164	.86638	.86118	.85605	.85098
93	.87761	.87257	.86759	.86267	.85781
94	.88290	.87806	.87327	.86854	.86386
95	.88750	.88282	.87820	.87364	.86913
96	.89136	.88683	.88236	.87793	.87355
97	.89481	.89041	.88606	.88176	.87750
98	.89783	.89354	.88930	.88511	.88096
99	.90067	.89649	.89235	.88826	.88420
100 ..	.90349	.89941	.89538	.89138	.88743
101 ..	.90600	.90202	.89807	.89416	.89029
102 ..	.90873	.90484	.90099	.89717	.89339
103 ..	.91217	.90841	.90468	.90099	.99733
104 ..	.91553	.91188	.90827	.90469	.90114
105 ..	.92047	.91701	.91358	.91018	.90680
106 ..	.92819	.92504	.92191	.91880	.91571
107 ..	.93868	.93596	.93325	.93056	.92788
108 ..	.95471	.95267	.95064	.94862	.94661
109 ..	.97985	.97893	.97801	.97710	.97619

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	5.2%	5.4%	5.6%	5.8%	6.0%
0	.06126	.05759	.05433	.05143	.04884
1	.04480	.04096	.03754	.03450	.03179
2	.04591	.04194	.03841	.03527	.03246
3	.04745	.04336	.03972	.03646	.03355
4	.04924	.04502	.04125	.03789	.03487
5	.05124	.04689	.04300	.03952	.03639
6	.05342	.04893	.04492	.04131	.03808
7	.05574	.05112	.04697	.04324	.03990
8	.05822	.05346	.04918	.04533	.04186
9	.06089	.05598	.05156	.04759	.04400
10	.06372	.05866	.05411	.05000	.04630
11	.06673	.06153	.05684	.05260	.04877
12	.06992	.06457	.05973	.05536	.05141
13	.07322	.06772	.06274	.05824	.05415
14	.07659	.07093	.06581	.06117	.05695
15	.07998	.07417	.06890	.06411	.05976
16	.08337	.07739	.07197	.06704	.06255
17	.08675	.08062	.07504	.06996	.06533
18	.09018	.08387	.07813	.07290	.06813
19	.09367	.08720	.08130	.07591	.07099
20	.09730	.09065	.08458	.07904	.07397
21	.10106	.09423	.08800	.08229	.07707
22	.10496	.09796	.09155	.08568	.08030
23	.10903	.10185	.09526	.08923	.08368
24	.11330	.10594	.09918	.09297	.08726
25	.11782	.11028	.10334	.09696	.09108
26	.12262	.11489	.10778	.10122	.09518
27	.12771	.11979	.11249	.10576	.09955
28	.13309	.12499	.11751	.11060	.10421
29	.13873	.13044	.12278	.11570	.10914
30	.14464	.13617	.12833	.12107	.11433
31	.15079	.14214	.13412	.12668	.11977
32	.15722	.14838	.14018	.13256	.12548
33	.16391	.15490	.14652	.13873	.13147
34	.17087	.16168	.15312	.14515	.13772
35	.17811	.16874	.16001	.15186	.14426
36	.18562	.17608	.16717	.15886	.15108
37	.19340	.18369	.17462	.16613	.15819
38	.20144	.19157	.18233	.17368	.16557
39	.20974	.19971	.19031	.18149	.17322
40	.21830	.20812	.19856	.18959	.18115
41	.22714	.21681	.20710	.19797	.18938
42	.23627	.22579	.21594	.20665	.19791
43	.24566	.23505	.22505	.21562	.20673
44	.25532	.24458	.23445	.22488	.21585
45	.26522	.25436	.24410	.23440	.22523
46	.27538	.26441	.25402	.24420	.23490
47	.28579	.27471	.26421	.25427	.24484
48	.29647	.28529	.27469	.26463	.25508
49	.30739	.29613	.28543	.27527	.26562
50	.31859	.30724	.29646	.28620	.27645
51	.33001	.31860	.30774	.29740	.28755
52	.34167	.33020	.31928	.30886	.29893
53	.35355	.34204	.33105	.32057	.31056
54	.36562	.35407	.34304	.33250	.32243
55	.37787	.36630	.35523	.34465	.33452
56	.39029	.37870	.36761	.35699	.34682
57	.40289	.39130	.38020	.36956	.35935
58	.41565	.40408	.39297	.38231	.37208
59	.42859	.41704	.40595	.39529	.38504
60	.44170	.43019	.41912	.40847	.39822
61	.45499	.44353	.43250	.42187	.41164
62	.46845	.45706	.44607	.43548	.42527
63	.48208	.47076	.45984	.44930	.43913
64	.49583	.48461	.47377	.46329	.45317
65	.50971	.49859	.48784	.47744	.46738

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	5.2%	5.4%	5.6%	5.8%	6.0%
66	.52369	.51269	.50204	.49173	.48175
67	.53774	.52688	.51635	.50614	.49625
68	.55187	.54115	.53075	.52066	.51088
69	.56607	.55551	.54526	.53530	.52563
70	.58035	.56997	.55987	.55006	.54053
71	.59474	.58455	.57463	.56498	.55559
72	.60923	.59924	.58952	.58004	.57082
73	.62375	.61398	.60446	.59518	.58613
74	.63818	.62864	.61933	.61026	.60140
75	.65240	.64310	.63402	.62515	.61649
76	.66636	.65731	.64846	.63981	.63135
77	.68005	.67124	.66263	.65420	.64596
78	.69347	.68492	.67655	.66836	.66033
79	.70669	.69840	.69028	.68232	.67452
80	.71973	.71171	.70384	.69613	.68856
81	.73252	.72477	.71717	.70970	.70237
82	.74499	.73751	.73016	.72295	.71587
83	.75713	.74992	.74284	.73589	.72905
84	.76901	.76208	.75527	.74857	.74198
85	.78067	.77402	.76748	.76104	.75471
86	.79185	.78548	.77921	.77304	.76695
87	.80228	.79617	.79015	.78423	.77838
88	.81193	.80607	.80029	.79460	.78899
89	.82102	.81540	.80985	.80438	.79899
90	.82979	.82441	.81909	.81384	.80867
91	.83820	.83304	.82795	.82292	.81796
92	.84598	.84104	.83616	.83134	.82657
93	.85300	.84826	.84357	.83894	.83437
94	.85924	.85468	.85017	.84570	.84130
95	.86466	.86025	.85589	.85158	.84732
96	.86922	.86494	.86071	.85652	.85238
97	.87329	.86913	.86501	.86093	.85690
98	.87685	.87279	.86877	.86479	.86085
99	.88019	.87622	.87230	.86841	.86456
100 ..	.88351	.87964	.87580	.87200	.86824
101 ..	.88646	.88267	.87891	.87519	.87150
102 ..	.88965	.88594	.88227	.87863	.87503
103 ..	.89370	.89011	.88654	.88301	.87952
104 ..	.89763	.89414	.89068	.88725	.88385
105 ..	.90345	.90013	.89683	.89356	.89032
106 ..	.91265	.90961	.90658	.90358	.90060
107 ..	.92522	.92258	.91995	.91734	.91474
108 ..	.94461	.94262	.94063	.93866	.93670
109 ..	.97529	.97438	.97348	.97259	.97170

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
0	.04653	.04447	.04262	.04095	.03946
1	.02937	.02720	.02525	.02351	.02194
2	.02994	.02769	.02567	.02385	.02221
3	.03094	.02860	.02650	.02460	.02290
4	.03216	.02973	.02755	.02558	.92380
5	.03359	.03106	.02879	.02674	.02488
6	.03517	.03255	.03019	.02805	.02612
7	.03688	.03416	.03171	.02949	.02747
8	.03874	.03592	.03337	.03106	.02896

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
9	.04077	.03784	.03519	.03279	.03061
10	.04295	.03992	.03717	.03467	.03240
11	.04531	.04217	.03931	.03672	.03436
12	.04782	.04457	.04161	.03892	.02647
13	.05045	.04708	.04402	.04122	.03868
14	.05312	.04964	.04646	.04357	.04093
15	.05581	.05220	.04891	.04591	.04317
16	.05847	.05474	.05134	.04822	.04538
17	.06111	.05726	.05374	.05051	.04756
18	.06378	.05979	.05615	.05280	.04974
19	.06650	.06238	.05861	.05514	.05196
20	.06933	.06507	.06117	.05758	.05429
21	.07228	.06788	.06384	.06013	.05671
22	.07535	.07081	.06664	.06279	.05925
23	.07858	.07389	.06958	.06559	.06192
24	.08201	.07717	.07270	.06858	.06477
25	.08567	.08067	.07606	.07179	.06785
26	.08960	.08444	.07968	.07527	.07118
27	.09380	.08849	.08357	.07901	.07478
28	.09830	.09283	.08775	.08304	.07867
29	.10306	.09742	.09218	.08732	.08280
30	.10808	.10228	.09688	.09187	.08720
31	.11335	.10738	.10182	.09665	.09182
32	.11889	.11275	.10704	.10170	.09672
33	.12471	.11840	.11252	.10703	.10189
34	.13079	.12432	.11827	.11261	.10732
35	.13716	.13052	.12431	.11849	.11305
36	.14381	.13701	.13063	.12465	.11905
37	.15075	.14378	.13724	.13110	.12534
38	.15796	.15083	.14412	.13782	.13190
39	.16545	.15815	.15129	.14483	.13875
40	.17322	.16576	.15874	.15212	.14589
41	.18129	.17367	.16649	.15971	.15332
42	.18967	.18190	.17456	.16763	.16108
43	.19834	.19041	.18293	.17585	.16915
44	.20731	.19924	.19160	.18437	.17753
45	.21655	.20834	.20055	.19318	.18619
46	.22608	.21773	.20981	.20229	.19516
47	.23590	.22741	.21935	.21170	.20443
48	.24602	.23741	.22922	.22144	.21403
49	.25644	.24770	.23939	.23148	.22394
50	.26716	.25831	.24989	.24185	.23419
51	.27816	.26921	.26068	.25253	.24475
52	.28945	.28040	.27176	.26351	.25562
53	.30100	.29187	.28313	.27478	.26679
54	.31279	.30357	.29475	.28631	.27822
55	.32482	.31553	.30663	.29810	.28992
56	.33707	.32771	.31875	.31014	.30188
57	.34955	.34015	.33112	.32244	.31411
58	.36225	.35280	.34372	.33499	.32659
59	.37519	.36571	.35659	.34781	.33936
60	.38836	.37886	.36971	.36089	.35239
61	.40177	.39226	.38309	.37425	.36572
62	.41542	.40591	.39674	.38788	.37932
63	.42930	.41981	.41064	.40178	.39321
64	.44338	.43392	.42477	.41591	.40734
65	.45765	.44823	.43910	.43027	.42171
66	.47208	.46271	.45364	.44483	.43630
67	.48666	.47736	.46834	.45958	.45108
68	.50138	.49215	.48320	.47450	.46605
69	.51624	.50711	.49824	.48961	.48122
70	.53125	.52223	.51345	.50491	.49660
71	.54645	.53755	.52889	.52045	.51223
72	.56183	.55307	.54453	.53621	.52809
73	.57731	.56870	.56030	.55211	.54412
74	.59275	.58431	.57606	.56801	.56015

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
75	.60803	.59976	.59168	.58379	.57607
76	.62308	.61500	.60709	.59936	.59179
77	.63789	.63000	.62227	.61470	.60730
78	.65247	.64477	.63723	.62984	.62261
79	.66687	.65938	.65203	.64483	.63777
80	.68114	.67386	.66672	.65971	.65284
81	.69518	.68812	.68119	.67438	.66770
82	.70891	.70207	.69535	.68875	.68227
83	.72232	.71572	.70922	.70283	.69655
84	.73550	.72913	.72285	.71668	.71061
85	.74847	.74234	.73630	.73035	.72449
86	.76096	.75506	.74925	.74353	.73789
87	.77263	.76696	.76137	.75585	.75042
88	.78345	.77799	.77261	.76730	.76207
89	.79367	.78842	.78323	.77812	.77308
90	.80356	.79851	.79353	.78862	.78376
91	.81306	.80821	.80344	.79871	.79405
92	.82187	.81722	.81263	.80810	.80361
93	.82984	.82538	.82096	.81659	.81228
94	.83694	.83263	.82837	.82416	.81999
95	.84310	.83893	.83481	.83073	.82670
96	.84829	.84424	.84023	.83626	.83234
97	.85291	.84897	.84506	.84120	.83738
98	.85696	.85310	.84929	.84551	.84177
99	.86075	.85698	.85325	.84956	.84590
100 ..	.86452	.86084	.85719	.85357	.85000
101 ..	.86785	.86424	.86066	.85711	.85360
102 ..	.87146	.86792	.86442	.86094	.85750
103 ..	.87605	.87261	.86921	.86583	.86248
104 ..	.88047	.87713	.87382	.87053	.86727
105 ..	.88710	.88390	.88073	.87758	.87446
106 ..	.89764	.89471	.89179	.88889	.88601
107 ..	.91216	.90960	.90705	.90451	.90199
108 ..	.93474	.93280	.93086	.92894	.92702
109 ..	.97081	.96992	.96904	.96816	.96729

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03811	.03689	.03579	.03479	.03388
1	.02052	.01924	.01809	.01704	.01609
2	.02074	.01940	.01819	.01710	.01611
3	.02136	.01996	.01870	.01756	.01652
4	.02219	.02074	.01942	.01822	.01713
5	.02321	.02169	.02031	.01905	.01791
6	.02437	.02278	.02134	.02003	.01883
7	.02565	.02399	.02248	.02111	.01986
8	.02706	.02533	.02376	.02232	.02101
9	.02863	.02682	.02518	.02367	.02230
10	.03034	.02846	.02674	.02517	.02373
11	.03221	.03025	.02846	.02682	.02532
12	.03424	.03219	.03032	.02861	.02704
13	.03635	.03422	.03228	.03049	.02885
14	.03851	.03630	.03427	.03240	.03069
15	.04066	.03836	.03624	.03430	.03252
16	.04277	.04037	.03817	.03615	.03429
17	.04485	.04236	.04007	.03796	.03602

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
18	.04693	.04434	.04196	.03976	.03773
19	.04904	.04635	.04387	.04159	.03947
20	.05125	.04845	.04588	.04349	.04129
21	.05356	.05065	.04797	.04549	.04319
22	.05597	.05295	.05016	.04758	.04519
23	.05853	.05539	.05248	.04979	.04730
24	.06124	.05799	.05497	.05217	.04957
25	.06420	.06081	.05767	.05475	.05205
26	.06739	.06388	.06062	.05758	.05476
27	.07086	.06721	.06382	.06067	.05773
28	.07460	.07082	.06730	.06402	.06097
29	.07859	.07467	.07102	.06762	.06444
30	.08284	.07879	.07500	.07146	.06815
31	.08733	.08312	.07920	.07553	.07209
32	.09207	.08773	.08366	.07986	.07629
33	.09709	.09260	.08839	.08445	.08075
34	.10237	.09773	.09338	.08929	.08546
35	.10794	.10315	.09865	.09442	.09045
36	.11379	.10884	.10420	.09983	.09572
37	.11992	.11483	.11003	.10552	.10126
38	.12633	.12108	.11614	.11148	.10708
39	.13302	.12762	.12253	.11772	.11318
40	.14000	.13445	.12921	.12425	.11957
41	.14728	.14158	.13619	.13109	.12626
42	.15490	.14904	.14350	.13825	.13328
43	.16260	.15680	.15111	.145072	.14060
44	17104	.16488	.15905	.15351	.14825
45	.17955	.17326	.16727	.16159	.15619
46	.18838	.18194	.17582	.16999	.16445
47	.19751	.19093	.18467	.17870	.17302
48	.20698	.20026	.19386	.18776	.18194
49	.21676	.20991	.20338	.19715	.19119
50	.22689	.21991	.21325	.20689	.20080
51	.23732	.23023	.22344	.21695	.21074
52	.24808	.24086	.23396	.22735	.22102
53	.25914	.25181	.24479	.23807	.24252
54	.27047	.26304	.25591	.24908	.25372
55	.28208	.27455	.26733	.26039	.25372
56	.29395	.28633	.37901	.27197	.26521
57	.30610	.29840	.29099	.28386	.27700
58	.31851	.31074	.30325	.29604	.28909
59	.33122	.32337	.31581	.30853	.30150
60	.34420	.33630	.32867	.32132	.31422
61	.35748	.34953	.34185	.33444	.32727
62	.37106	.36307	.35535	.34788	.34066
63	.38492	.37691	.36915	.36165	.35438
64	.39905	.39102	.38324	.37571	.36841
65	.41342	.40539	.39760	.39005	.38272
66	.42803	.42000	.41221	.40465	.39731
67	.44283	.43483	.42705	.41949	.41215
68	.45784	.44987	.44211	.43457	.42724
69	.47307	.46513	.45741	.44990	.44254
70	.48851	.48063	.47296	.46549	.45821
71	.50422	.49641	.48880	.48139	.47416
72	.52018	.51246	.50493	.49758	.49042
73	.53631	.52870	.52126	.51400	.50691
74	.55247	.54497	.53764	.53048	.52347
75	.56852	.56115	.55393	.54687	.53997
76	.58439	.57714	.57005	.56311	.55632
77	.60005	.59294	.58599	.57917	.57249
78	.61551	.60856	.60174	.59506	.58851
79	.63084	.62405	.61739	.61085	.60443
80	.64609	.63946	.63296	.62657	.62030
81	.66114	.65469	.64835	.64213	.63602
82	.67589	.66963	.66347	.65742	.65146
83	.60937	.68429	.67831	.67243	.66664

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
84	.70463	.69875	.69296	.68726	.68165
85	.71872	.71304	.70745	.70194	.69651
86	.73233	.72685	.72146	.71614	.71089
87	.74507	.73978	.73458	.72944	.72438
88	.75691	.75181	.74679	.74183	.73694
89	.76810	.76319	.75834	.75355	.74883
90	.77897	.77424	.76957	.76496	.76040
91	.78945	.78490	.78040	.77596	.77158
92	.79919	.79481	.79048	.78621	.78198
93	.80801	.80380	.79963	.79550	.79143
94	.81587	.81180	.80777	.80379	.79985
95	.82271	.81877	.81487	.81100	.80719
96	.82846	.82462	.82083	.81707	.81335
97	.83360	.82985	.82615	.82248	.81885
98	.33808	.83441	.83079	.82720	.82365
99	.84228	.83869	.83514	.83163	.82815
100 ..	.84645	.84294	.83947	.83603	.83262
101 ..	.85012	.84668	.84327	.83988	.83653
102 ..	.85409	.85072	.84737	.84405	.84077
103 ..	.85917	.85588	.85262	.84939	.84619
104 ..	.86403	.86083	.85765	.85449	.85136
105 ..	.87136	.86829	.86524	.86221	.85921
106 ..	.88315	.88032	.87750	.87470	.87192
107 ..	.89949	.89700	.89452	.89206	.88961
108 ..	.92511	.92321	.92132	.91944	.91757
109 ..	.96642	.96555	.96468	.96382	.96296

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	8.2%	8.4%	8.6%	8.8%	9.0%
0	.03305	.03230	.03161	.03098	.03040
1	.01523	.01444	.01372	.01307	.01247
2	.01520	.01438	.01362	.01294	.01230
3	.01557	.01470	.01391	.01319	.01253
4	.01613	.01522	.01439	.01363	.01294
5	.01687	.01591	.01504	.01424	.01351
6	.01774	.01674	.01582	.01498	.01421
7	.01871	.01766	.01670	.01581	.01500
8	.01980	.01870	.01769	.01676	.01591
9	.02104	.01989	.01883	.01785	.01695
10	.02241	.02120	.02009	.01906	.01812
11	.02394	.02267	.02150	.02042	.01943
12	.02560	.02427	.02305	.02192	.02088
13	.02734	.02595	.02467	.02349	.02240
14	.02912	.02766	.02632	.02509	.02394
15	.03087	.02935	.02795	.02666	.02546
16	.03257	.03099	.02952	.02817	.02691
17	.03423	.03257	.03104	.02962	.02831
18	.03586	.03414	.03253	.03105	.02967
19	.03752	.03572	.03404	.03249	.03105
20	.03925	.03737	.03562	.03399	.03248
21	.04107	.03910	.03727	.03557	.03398
22	.04297	.04091	.03899	.03722	.03556
23	.04498	.04283	.04083	.03897	.03723
24	.04715	.04491	.04282	.04087	.03905
25	.04953	.04718	.04499	.04295	.04105
26	.05213	.04968	.04740	.04527	.04327

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	8.2%	8.4%	8.6%	8.8%	9.0%
27	.05499	.05243	.05005	.04782	.04573
28	.05811	.05545	.05295	.05062	.04844
29	.06146	.05868	.05608	.05365	.05136
30	.06506	.06217	.05945	.05691	.05452
31	.06888	.06586	.06303	.06038	.05789
32	.07295	.06981	.06687	.06410	.06149
33	.07728	.07401	.07095	.06806	.06535
34	.08185	.07846	.07527	.07227	.06944
35	.08671	.08319	.07988	.07675	.07380
36	.09184	.08819	.08475	.08150	.07843
37	.09725	.09347	.08989	.08652	.08332
38	.10293	.09901	.09531	.09180	.08848
39	.10889	.10483	.10099	.09736	.09391
40	.11514	.11094	.10697	.10320	.09963
41	.12168	.11735	.11324	.10934	.10564
42	.12856	.12409	.11984	.11581	.11197
43	.13574	.13113	.12675	.12258	.11862
44	.14325	.13850	.13398	.12967	.12558
45	.15105	.14616	.14150	.13706	.13283
46	.15917	.15414	.14935	.14478	.14041
47	.16760	.16244	.15751	.15280	.14831
48	.17639	.17109	.16602	.16119	.15656
49	.18551	.18007	.17488	.16991	.16516
50	.19499	.18942	.18410	.17900	.17412
51	.20480	.19911	.19366	.18844	.18343
52	.21495	.20914	.20357	.19822	.19309
53	.22544	.21951	.21381	.20835	.20309
54	.23622	.23018	.22437	.21878	.21341
55	.24732	.24116	.23524	.22954	.22406
56	.25870	.25244	.24641	.24060	.23501
57	.27040	.26404	.25791	.25200	.24630
58	.28239	.27594	.26971	.26370	.25791
59	.29472	.28817	.28186	.27576	.26987
60	.30736	.30074	.29434	.28816	.28218
61	.32035	.31365	.30718	.30092	.29486
62	.33368	.32692	.32038	.31405	.30791
63	.34735	.34054	.33394	.32754	.32134
64	.36133	.35448	.34783	.34138	.33512
65	.37562	.36873	.36204	.35554	.34924
66	.39019	.38327	.37655	.37002	.36367
67	.40502	.39809	.39134	.38479	.37841
68	.42011	.41317	.40642	.39985	.39345
69	.43547	.42854	.42179	.41522	.40882
70	.45112	.44421	.43748	.43091	.42451
71	.46711	.46023	.45352	.44698	.44059
72	.48342	.47659	.46992	.46341	.45705
73	.49998	.49321	.48660	.48014	.47382
74	.51663	.50994	.50339	.49699	.49073
75	.53322	.52661	.52014	.51381	.50762
76	.54967	.54315	.53678	.53053	.52440
77	.56595	.55954	.55326	.54710	.54106
78	.58209	.57579	.56961	.56355	.55761
79	.59814	.59196	.58590	.57995	.57410
80	.61415	.60810	.60217	.59633	.59060
81	.63001	.62410	.61830	.61260	.60699
82	.64561	.63985	.63419	.62862	.62314
83	.66095	.65535	.64983	.64441	.63907
84	.67612	.67068	.66533	.66005	.65486
85	.69116	.68589	.68070	.67559	.67055
86	.70573	.70063	.69561	.69066	.68578
87	.71939	.71446	.70961	.70481	.70009
88	.73211	.72735	.72265	.71801	.71343
89	.74417	.73956	.73501	.73053	.72609
90	.75590	.75146	.74707	.74273	.73845
91	.76724	.76296	.75873	.75454	.75041
92	.77781	.77368	.76960	.76556	.76158

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	8.2%	8.4%	8.6%	8.8%	9.0%
93	.78740	.78342	.77948	.77558	.77173
94	.79596	.79210	.78829	.78452	.78079
95	.80341	.79967	.79597	.79231	.78869
96	.80967	.80603	.80242	.79885	.79532
97	.81526	.81170	.80818	.80470	.80125
98	.82013	.81665	.81320	.80979	.80641
99	.82470	.82129	.81791	.81456	.81125
100 ..	.82924	.82590	.82258	.81930	.81605
101 ..	.83322	.82993	.82667	.82344	.82024
102 ..	.83751	.83428	.83108	.82791	.82477
103 ..	.84301	.83986	.83674	.83365	.83058
104 ..	.84826	.84518	.84213	.83910	.83610
105 ..	.85623	.85327	.85033	.84741	.84452
106 ..	.86915	.86641	.86369	.86098	.85829
107 ..	.88718	.88476	.88236	.87997	.87759
108 ..	.91571	.91385	.91201	.91017	.90834
109 ..	.96211	.96125	.96041	.95956	.95872

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02987	.02938	.02893	.02851	.02812
1	.01192	.01141	.01094	.01051	.01012
2	.01173	.01119	.01070	.01025	.00983
3	.01192	.01136	.01084	.01036	.00992
4	.01229	.01170	.01116	.01066	.01019
5	.01283	.01221	.01164	.01111	.01062
6	.01350	.01284	.01224	.01168	.01116
7	.01425	.01356	.01292	.01233	.01178
8	.01512	.01439	.01372	.01309	.01252
9	.01612	.01535	.01464	.01398	.01337
10	.01724	.01644	.01569	.01499	.01435
11	.01851	.01766	.01688	.01615	.01547
12	.01991	.01902	.01819	.01742	.01671
13	.02139	.02045	.01958	.01877	.01802
14	.02288	.02190	.02098	.02013	.01934
15	.02435	.02331	.02235	.02146	.02063
16	.02575	.02466	.02366	.02272	.02185
17	.02709	.02595	.02490	.02391	.02300
18	.02839	.02721	.02610	.02507	.02410
19	.02971	.02846	.02730	.02621	.02520
20	.03108	.02977	.02855	.02741	.02635
21	.03251	.03114	.02986	.02866	.02755
22	.03402	.03258	.03123	.02998	.02880
23	.03562	.03410	.03269	.03137	.03014
24	.03735	.03577	.03428	.03290	.03159
25	.03927	.03761	.03605	.03459	.03322
26	.04141	.03966	.03803	.03649	.03505
27	.04377	.04194	.04023	.03861	.03710
28	.04639	.04447	.04267	.04098	.03938
29	.04922	.04721	.04532	.04354	.04187
30	.05228	.05017	.04819	.04633	.04457
31	.05554	.05334	.05126	.04930	.04746
32	.05904	.05674	.05456	.05251	.05058
33	.06279	.06038	.05810	.05595	.05392
34	.06677	.06435	.06187	.05962	.05750
35	.07102	.06839	.06590	.06355	.06132

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	9.2%	9.4%	9.6%	9.8%	10.0%
36	.07553	.07278	.07019	.06773	.06540
37	.08030	.07745	.07474	.07217	.06974
38	.08534	.08237	.07955	.07687	.07433
39	.09065	.08755	.08462	.08182	.07917
40	.09624	.09302	.08996	.08706	.08429
41	.10212	.09878	.09560	.09258	.08970
42	.10833	.10486	.10156	.09842	.09543
43	.11484	.11125	.10783	.10456	.10145
44	.12167	.11795	.11441	.11102	.10779
45	.12880	.12495	.12128	.11777	.11442
46	.13625	.13227	.12847	.12484	.12137
47	.14402	.13991	.13599	.13223	.12863
48	.15214	.14791	.14385	.13997	.13626
49	.16060	.15625	.15207	.14806	.14422
50	.16944	.16496	.16065	.15653	.15257
51	.17862	.17401	.16959	.16534	.16126
52	.18816	.18343	.17888	.17451	.17031
53	.19805	.19320	.18853	.18404	.17972
54	.20825	.20328	.19850	.19390	.18946
55	.21878	.21370	.20881	.20409	.19954
56	.22963	.22443	.21943	.21460	.20994
57	.24081	.23551	.23040	.22546	.22069
58	.25231	.24691	.24170	.23665	.23178
59	.26418	.25868	.25336	.24822	.24325
60	.27640	.27081	.26540	.26016	.25509
61	.28899	.28332	.27782	.27249	.26733
62	.30197	.29622	.29064	.28523	.27998
63	.31533	.30950	.30385	.29836	.29304
64	.32905	.32316	.31743	.31188	.30648
65	.34311	.33716	.33138	.32576	.32030
66	.35751	.35151	.34568	.34001	.33449
67	.37221	.36618	.36030	.35459	.34902
68	.38723	.38116	.37526	.36950	.36390
69	.40257	.39649	.39056	.38478	.37914
70	.41826	.41217	.40623	.40043	.39478
71	.43435	.42827	.42233	.41652	.41086
72	.45084	.44478	.43885	.43305	.42739
73	.46765	.46161	.45571	.44994	.44429
74	.48460	.47861	.47274	.46700	.46138
75	.50155	.49561	.48979	.48409	.47851
76	.51841	.51253	.50677	.50112	.49559
77	.53514	.52934	.52364	.51806	.51258
78	.55177	.54605	.54043	.53492	.52951
79	.56837	.56273	.55720	.55177	.54643
80	.58497	.57944	.57401	.56866	.56341
81	.60148	.59606	.59073	.58548	.58033
82	.61775	.61245	.60723	.60210	.59705
83	.63381	.62863	.62354	.61852	.61358
84	.64974	.64470	.63973	.63484	.63002
85	.66558	.66068	.65586	.65110	.64641
86	.68096	.67622	.67154	.66692	.66236
87	.69542	.69082	.68628	.68180	.67738
88	.70891	.70445	.70005	.69570	.69141
89	.72172	.71739	.71312	.70891	.70474
90	.73422	.73004	.72591	.72182	.71779
91	.74632	.74229	.73829	.73435	.73045
92	.75763	.75373	.74988	.74606	.74229
93	.76791	.76414	.76042	.75673	.75308
94	.77710	.77345	.76983	.76626	.76272
95	.78510	.78155	.77804	.77457	.77113
96	.79183	.78837	.78494	.78155	.77819
97	.79783	.79445	.79110	.78779	.78450
98	.80306	.79975	.79647	.79322	.79000
99	.80797	.80471	.80149	.79830	.79514
100 ..	.81283	.80964	.80648	.80335	.80025
101 ..	.81708	.81394	.81082	.80774	.80468

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	9.2%	9.4%	9.6%	9.8%	10.0%
102 ..	.82165	.81856	.81550	.81247	.80946
103 ..	.82754	.82452	.82153	.81857	.81563
104 ..	.83312	.83017	.82723	.82433	.82144
105 ..	.84165	.83880	.83597	.83316	.83038
106 ..	.85562	.85297	.85034	.84772	.84512
107 ..	.87523	.87288	.87054	.86822	.86591
108 ..	.90652	.90471	.90291	.90111	.89932
109 ..	.95788	.95704	.95620	.95537	.95455

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	10.2%	10.4%	10.6%	10.8%	11.0%
0	.02776	.02743	.02712	.02682	.02655
1	.00975	.00941	.00909	.00880	.00852
2	.00945	.00909	.00875	.00844	.00816
3	.00952	.00914	.00879	.00846	.00815
4	.00976	.00936	.00899	.00865	.00832
5	.01016	.00974	.00935	.00898	.00864
6	.01068	.01023	.00981	.00943	.00907
7	.01128	.01080	.01036	.00995	.00957
8	.01198	.01148	.01101	.01058	.01017
9	.01281	.01228	.01179	.01133	.01090
10	.01375	.01319	.01267	.01219	.01173
11	.01483	.01425	.01370	.01318	.01270
12	.01604	.01542	.01484	.01430	.01379
13	.01732	.01666	.01605	.01548	.01494
14	.01860	.01792	.01727	.01667	.01610
15	.01986	.01913	.01845	.01782	.01723
16	.02103	.02027	.01956	.01889	.01827
17	.02214	.02134	.02059	.01989	.01923
18	.02320	.02236	.02157	.02084	.02014
19	.02426	.02337	.02254	.02177	.02104
20	.02536	.02442	.02355	.02273	.02197
21	.02650	.02552	.02460	.02374	.02293
22	.02770	.02667	.02570	.02479	.02394
23	.02898	.02789	.02687	.02591	.02501
24	.03037	.02923	.02815	.02714	.02619
25	.03194	.03073	.02960	.02853	.02752
26	.03370	.03243	.03123	.03010	.02904
27	.03568	.03434	.03307	.03188	.03076
28	.03789	.03647	.03514	.03389	.03271
29	.04029	.03880	.03740	.03608	.03483
30	.04291	.04135	.03987	.03848	.03716
31	.04572	.04407	.04252	.04105	.03966
32	.04875	.04702	.04538	.04384	.04237
33	.05200	.05019	.04847	.04684	.04530
34	.05548	.05358	.05177	.05006	.04843
35	.05921	.05722	.05532	.05352	.05181
36	.06319	.06110	.05911	.05722	.05543
37	.06743	.06524	.06315	.06117	.05929
38	.07191	.06962	.06744	.06536	.06338
39	.07665	.074425	.07197	.06980	.06773
40	.08166	.07916	.07677	.07450	.07233
41	.08696	.08434	.08185	.07947	.07721
42	.09257	.08985	.08725	.08477	.08239
43	.09848	.09564	.09293	.09034	.08787
44	.10470	.10175	.09893	.09623	.09365

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	10.2%	10.4%	10.6%	10.8%	11.0%
45	.11121	.10815	.10522	.10241	.09972
46	.11805	.11486	.11182	.10890	.10610
47	.12519	.12189	.11873	.11569	.11279
48	.13269	.12927	.12600	.12285	.11983
49	.14054	.13600	.13361	.13035	.12721
50	.14876	.14511	.14160	.13822	.13497
51	.15734	.15356	.14994	.14645	.14309
52	.16627	.16238	.15864	.15504	.15156
53	.17557	.17156	.16770	.16399	.16040
54	.18519	.18107	.17710	.17327	.16957
55	.19515	.19092	.18684	.18290	.17909
56	.20544	.20110	.19691	.19286	.18894
57	.21609	.21164	.20734	.20318	.19916
58	.22707	.22252	.21811	.21385	.20972
59	.23844	.23378	.22928	.22491	.22068
60	.25018	.24543	.24082	.23636	.23203
61	.26233	.25749	.25279	.24823	.24381
62	.27490	.26996	.26517	.26052	.25601
63	.28787	.28286	.27798	.27325	.26865
64	.30124	.29615	.29120	.28639	.28171
65	.31500	.30983	.30481	.29993	.29517
66	.32912	.32390	.31881	.31386	.30904
67	.34360	.33832	.33318	.32817	.32328
68	.35843	.35311	.34791	.34285	.33791
69	.37365	.36828	.36305	.35794	.35296
70	.38925	.38386	.37860	.37346	.36844
71	.40532	.39991	.39463	.38946	.38442
72	.42185	.41644	.41115	.40597	.40091
73	.43876	.43336	.42807	.42289	.41782
74	.45588	.45050	.44522	.44005	.43499
75	.47304	.46769	.46244	.45729	.45225
76	.49016	.48485	.47963	.47451	.46949
77	.50721	.50193	.49676	.49168	.48670
78	.52419	.51898	.51385	.50882	.50388
79	.54119	.53604	.53097	.52600	.52111
80	.55825	.55318	.54819	.54328	.53846
81	.57526	.57027	.56536	.56053	.55578
82	.59208	.58718	.58236	.57762	.57295
83	.60871	.60392	.59920	.59455	.58997
84	.62527	.62059	.61597	.61143	.60695
85	.64179	.63723	.63273	.62830	.62393
86	.65787	.65344	.64907	.64475	.64050
87	.67302	.66871	.66446	.66026	.65612
88	.68717	.68298	.67885	.67477	.67074
89	.70063	.69656	.69255	.68858	.68466
90	.71380	.70986	.70597	.70212	.69831
91	.72659	.72278	.71901	.71528	.71160
92	.73856	.73488	.73123	.72762	.72405
93	.74947	.74590	.74236	.73887	.73541
94	.75922	.75575	.75233	.74893	.74557
95	.76773	.76436	.76102	.75772	.75445
96	.77487	.77158	.76832	.76510	.76190
97	.78125	.77803	.77485	.77169	.76856
98	.78681	.78365	.78052	.77742	.77435
99	.79201	.78891	.78583	.78279	.77977
100 ..	.79717	.79412	.79111	.78811	.78515
101 ..	.80165	.79865	.79568	.79273	.78981
102 ..	.80648	.80353	.80060	.79769	.79481
103 ..	.81271	.80982	.80695	.80411	.80129
104 ..	.81858	.81574	.81292	.81013	.80736
105 ..	.83761	.82487	.82214	.81943	.81675
106 ..	.84254	.83998	.83743	.83490	.83238
107 ..	.86362	.86133	.85906	.85681	.85456
108 ..	.89755	.89577	.89401	.89226	.89051
109 ..	.95372	.95290	.95208	.95126	.95045

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	11.2%	11.4%	11.6%	11.8%	12.0%
0	.02630	.02606	.02583	.02562	.02542
1	.00827	.00803	.00780	.00759	.00739
2	.00789	.00763	.00740	.00718	.00697
3	.00787	.00760	.00736	.00712	.00690
4	.00802	.00774	.00748	.00723	.00700
5	.00832	.00802	.00774	.00748	.00724
6	.00873	.00841	.00812	.00784	.00758
7	.00921	.00888	.00856	.00827	.00799
8	.00979	.00944	.00910	.00879	.00850
9	.01049	.01012	.00976	.00943	.00912
10	.01131	.01091	.01053	.01018	.00985
11	.01225	.01183	.01143	.01106	.01070
12	.01331	.01286	.01244	.01205	.01168
13	.01444	.01397	.01352	.01311	.01271
14	.01558	.01508	.01461	.01417	.01375
15	.01667	.01614	.01565	.01519	.01475
16	.01768	.01713	.01661	.01612	.01566
17	.01862	.01803	.01749	.01697	.01649
18	.01949	.01888	.01831	.01776	.01725
19	.02035	.01971	.01910	.01853	.01799
20	.02124	.02056	.01992	.01932	.01875
21	.02217	.02145	.02078	.02014	.01954
22	.02313	.02238	.02166	.02099	.02035
23	.02416	.02336	.02261	.02190	.02122
24	.02529	.02445	.02365	.02290	.02218
25	.02657	.02568	.02484	.02404	.02328
26	.02804	.02710	.02620	.02536	.02456
27	.02970	.02870	.02776	.02686	.02601
28	.03159	.03053	.02953	.02858	.02768
29	.03365	.03253	.03147	.03047	.02951
30	.03591	.03473	.03361	.03255	.03154
31	.03834	.03709	.03591	.03478	.03372
32	.04098	.03966	.03841	.03722	.03610
33	.04383	.04244	.04112	.03987	.03867
34	.04689	.04543	.04403	.04271	.04145
35	.05019	.04865	.04718	.04578	.04445
36	.05372	.05210	.05055	.04907	.04767
37	.05749	.05578	.05416	.05260	.05112
38	.06150	.05970	.05799	.05636	.05480
39	.06575	.06387	.06207	.06035	.05871
40	.07026	.06828	.06639	.06459	.06286
41	.07504	.07297	.07099	.06909	.06728
42	.08013	.07796	.07589	.07390	.07200
43	.08550	.08323	.08106	.07898	.07699
44	.09118	.08881	.08654	.08437	.08228
45	.09714	.09467	.09230	.09003	.08784
46	.10341	.10084	.09837	.09599	.09371
47	.10999	.10731	.10473	.10226	.09988
48	.11693	.11414	.11145	.10888	.10639
49	.12420	.12130	.11852	.11583	.11325
50	.13185	.12884	.12595	.12316	.12047
51	.13985	.13674	.13373	.13084	.12805
52	.14822	.14499	.14188	.13888	.13598
53	.15695	.15361	.15039	.14729	.14428
54	.16601	.16256	.15924	.15602	.15292
55	.17542	.17186	.16843	.16511	.16190
56	.18516	.18150	.17796	.17454	.17122
57	.19527	.19150	.18786	.18433	.18091
58	.20573	.20186	.19811	.19448	.19096
59	.21659	.21262	.20877	.20504	.20142
60	.22784	.22377	.21982	.21599	.21227
61	.23952	.23535	.23131	.22738	.22357
62	.25163	.24737	.24324	.23922	.23531
63	.26418	.25984	.25561	.25151	.24751
64	.27716	.27273	.26842	.26423	.26015
65	.29054	.28604	.28165	.27738	.27322

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	11.2%	11.4%	11.6%	11.8%	12.0%
66	.30434	.29976	.29530	.29096	.28672
67	.31852	.31388	.30935	.30494	.30063
68	.33310	.32840	.32381	.31933	.31496
69	.34809	.34334	.33870	.33417	.32975
70	.36353	.35874	.35405	.34948	.34500
71	.37948	.37466	.36994	.36532	.36081
72	.39595	.39111	.38636	.38172	.37718
73	.41286	.40801	.40325	.39859	.39403
74	.43004	.42518	.42042	.41575	.41118
75	.44730	.44245	.43770	.43304	.42846
76	.46457	.45974	.45500	.45035	.44579
77	.48181	.47700	.47229	.46766	.46311
78	.49903	.49426	.48958	.48497	.48045
79	.51631	.51159	.50694	.50238	.49789
80	.53371	.52905	.52446	.51994	.51550
81	.55110	.54650	.54197	.53752	.53313
82	.56835	.56382	.55937	.55497	.55065
83	.58546	.58101	.57663	.57231	.56806
84	.60253	.59817	.59388	.58965	.58547
85	.61961	.61536	.61116	.60703	.60294
86	.63630	.63215	.62806	.62402	.62004
87	.65203	.64800	.64401	.64007	.63619
88	.66676	.66282	.65894	.65510	.65131
89	.68079	.67696	.67318	.66944	.66574
90	.69455	.69084	.68716	.68353	.67993
91	.70795	.70435	.70078	.69726	.69377
92	.72052	.71703	.71357	.71015	.70677
93	.73198	.72860	.72524	.72192	.71864
94	.74225	.73896	.73570	.73248	.72928
95	.75121	.74801	.74483	.74169	.73858
96	.75874	.75561	.75250	.74943	.74639
97	.76546	.76240	.75936	.75635	.75336
98	.77131	.76830	.76531	.76235	.75942
99	.77678	.77382	.77088	.76798	.76509
100 ..	.78221	.77930	.77642	.77356	.77072
101 ..	.78691	.78404	.78119	.77837	.77557
102 ..	.79196	.78912	.78632	.78353	.78077
103 ..	.79849	.79572	.79297	.79024	.78753
104 ..	.80460	.80188	.79917	.79648	.79381
105 ..	.81408	.81143	.80881	.80620	.80361
106 ..	.82989	.82740	.82494	.82249	.82006
107 ..	.85233	.85012	.84791	.84572	.84353
108 ..	.88877	.88704	.88532	.88361	.88190
109 ..	.94964	.94883	.94803	.94723	.94643

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	12.2%	12.4%	12.6%	12.8%	13.0%
0	.02523	.02505	.02488	.02472	.02456
1	.00721	.00703	.00687	.00671	.00657
2	.00678	.00659	.00642	.00626	.00610
3	.00670	.00650	.00632	.00615	.00599
4	.00678	.00658	.00638	.00620	.00603
5	.00701	.00679	.00658	.00639	.00620
6	.00733	.00710	.00688	.00668	.00648
7	.00733	.00748	.00725	.00703	.00682
8	.00822	.00796	.00771	.00748	.00726

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	12.2%	12.4%	12.6%	12.8%	13.0%
9	.00882	.00854	.00828	.00803	.00780
10	.00953	.00924	.00896	.00869	.00844
11	.01037	.01006	.00976	.00948	.00922
12	.01132	.01099	.01068	.01038	.01010
13	.01234	.01199	.01166	.01134	.01104
14	.01336	.01299	.01264	.01231	.01199
15	.01434	.01395	.01358	.01323	.01289
16	.01522	.01481	.01442	.01405	.01371
17	.01603	.01559	.01518	.01480	.01443
18	.01677	.01631	.01588	.01547	.01508
19	.01748	.01700	.01654	.01611	.01570
20	.01821	.01770	.01722	.01677	.01633
21	.01897	.01843	.01792	.01744	.01698
22	.01975	.01918	.01864	.01813	.01765
23	.02059	.01998	.01941	.01887	.01836
24	.02151	.02087	.02027	.01970	.01915
25	.02257	.02189	.02125	.02064	.02006
26	.02380	.02308	.02240	.02175	.02114
27	.02521	.02445	.02373	.02304	.02239
28	.02683	.02602	.02525	.02452	.02383
29	.02861	.02775	.02694	.02616	.02543
30	.03058	.02967	.02881	.02798	.02720
31	.03270	.03174	.03082	.02995	.02911
32	.03502	.03400	.03303	.03210	.03122
33	.03754	.03646	.03543	.03444	.03350
34	.04025	.03910	.03801	.03697	.03597
35	.04318	.04197	.04081	.03971	.03865
36	.04633	.04505	.04383	.04266	.04154
37	.04971	.04836	.04707	.04583	.04465
38	.05331	.05188	.05052	.04922	.04797
39	.05714	.05564	.05420	.05282	.05150
40	.06121	.05963	.05812	.05667	.05528
41	.06554	.06388	.06229	.06076	.05929
42	.07018	.06843	.06675	.06514	.06360
43	.07508	.07324	.07148	.06979	.06817
44	.08028	.07325	.07651	.07473	.07303
45	.08575	.08373	.08180	.07993	.07814
46	.09152	.08941	.08738	.08543	.08355
47	.09759	.09539	.09326	.09122	.08926
48	.10401	.10171	.09949	.09735	.09530
49	.11076	.10836	.10605	.10382	.10167
50	.11788	.11538	.11297	.11065	.10840
51	.12535	.12276	.12025	.11782	.11548
52	.13319	.13049	.12788	.12536	.12292
53	.14139	.13858	.13588	.13326	.13072
54	.14992	.14701	.14420	.14149	.13885
55	.15880	.15579	.15288	.15006	.14733
56	.16801	.16491	.16190	.15898	.15615
57	.17760	.17439	.17128	.16827	.16534
58	.18755	.18424	.18103	.17792	.17489
59	.19790	.19450	.19119	.18798	.18486
60	.20866	.20516	.20175	.19844	.19523
61	.21986	.21626	.21276	.20936	.20605
62	.23151	.22782	.22423	.22073	.21733
63	.24362	.23984	.23616	.23257	.22908
64	.25617	.25231	.24854	.24487	.24129
65	.26917	.26522	.26137	.25761	.25395
66	.28259	.27857	.27464	.27081	.26707
67	.29643	.29233	.28833	.28443	.38061
68	.31070	.30653	.30246	.29849	.29461
69	.32542	.32120	.31707	.31303	.30908
70	.34063	.33635	.33217	.32807	.32407
71	.35639	.35207	.34784	.34370	.33965
72	.37273	.36837	.36410	.35993	.35583
73	.38955	.38517	.38088	.37667	.37255
74	.40670	.40230	.39799	.39377	.38962

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	12.2%	12.4%	12.6%	12.8%	13.0%
75	.42398	.41958	.41526	.41102	.40686
76	.44131	.43691	.43259	.42825	.42419
77	.45864	.45425	.44994	.44571	.44155
78	.47601	.47164	.46734	.46312	.45897
79	.49348	.48914	.48487	.48067	.47654
80	.51112	.50682	.50259	.49842	.49432
81	.52881	.52455	.52036	.51624	.51218
82	.54639	.54219	.53805	.53398	.52996
83	.56386	.55973	.55566	.55164	.54768
84	.58136	.57730	.57329	.56934	.56545
85	.59891	.59494	.59102	.58715	.58333
86	.61610	.61222	.60839	.60460	.60086
87	.62335	.62856	.62481	.62111	.61746
88	.64757	.64386	.64021	.63659	.63302
89	.66209	.65848	.65491	.65139	.64790
90	.67638	.67287	.66939	.66596	.66256
91	.69032	.68691	.68353	.68019	.67689
92	.70342	.70011	.69683	.69359	.69038
93	.71539	.71217	.70899	.70584	.70271
94	.72612	.72299	.71989	.71683	.71379
95	.73550	.43245	.72943	.72643	.72347
96	.74337	.74039	.73743	.73450	.73160
97	.75041	.74748	.74458	.74171	.73886
98	.74652	.75364	.75079	.74797	.74517
99	.76224	.75941	.75660	.75382	.75106
100 ..	.76791	.76513	.76237	.75963	.75692
101 ..	.77280	.77005	.76732	.67462	.76194
102 ..	.77804	.77532	.77263	.76996	.76732
103 ..	.78485	.78218	.77954	.77692	.77432
104 ..	.79117	.78854	.78594	.78335	.78078
105 ..	.80103	.79848	.78595	.79343	.79093
106 ..	.81764	.81524	.81285	.81048	.80813
107 ..	.84137	.93921	.83706	.83493	.83281
108 ..	.88020	.87851	.87682	.87515	.87348
109 ..	.94563	.94484	.94405	.94326	.94248

TABLE G

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	13.2%	13.4%	13.6%	13.8%	14.0%
0	.02442	.02428	.02414	.02402	.02389
1	.00643	.00629	.00617	.00605	.00594
2	.00596	.00582	.00569	.00556	.00544
3	.00583	.00569	.00555	.00542	.00529
4	.00586	.00571	.00556	.00542	.00529
5	.00603	.00587	.00571	.00556	.00542
6	.00630	.00612	.00595	.00580	.00565
7	.00663	.00644	.00626	.00610	.00594
8	.00705	.00685	.00666	.00648	.00631
9	.00757	.00736	.00716	.00697	.00679
10	.00821	.00798	.00777	.00756	.00737
11	.00896	.00872	.00850	.00828	.00807
12	.00983	.00958	.00934	.00911	.00889
13	.01076	.01049	.01024	.00999	.00976
14	.01170	.01141	.01114	.01088	.01064
15	.01258	.01228	.01200	.01172	.01147
16	.01337	.01306	.01276	.01247	.01220
17	.01408	.01375	.01343	.01313	.01284

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	13.2%	13.4%	13.6%	13.8%	14.0%
18	.01471	.01436	.01403	.01371	.01341
19	.01531	.01494	.01459	.01426	.01394
20	.01592	.01553	.01516	.01481	.01447
21	.01655	.01614	.01574	.01537	.01502
22	.01719	.01675	.01634	.01594	.01557
23	.01787	.01741	.01697	.01655	.01615
24	.01863	.01814	.01768	.01723	.01681
25	.01952	.01899	.01850	.01802	.01757
26	.02056	.02000	.01947	.01897	.01849
27	.02177	.02118	.02061	.02008	.01956
28	.02317	.02254	.02194	.02137	.02082
29	.02472	.02405	.02342	.02281	.02223
30	.02645	.02574	.02506	.02441	.02379
31	.02832	.02756	.02684	.02615	.02549
32	.03037	.02957	.02880	.02806	.02736
33	.03261	.03175	.03093	.03015	.02940
34	.03502	.03411	.03324	.03241	.03162
35	.03764	.03668	.03576	.03488	.03403
36	.04048	.03945	.03847	.03754	.03664
37	.04352	.04244	.04140	.04040	.03945
38	.04677	.04563	.04453	.04347	.04246
39	.05024	.04903	.04787	.04675	.04568
40	.05394	.05266	.05143	.05025	.04912
41	.05789	.05653	.05524	.05399	.05279
42	.06212	.06069	.05932	.05800	.05674
43	.06661	.06511	.06366	.06227	.06093
44	.07138	.06980	.06828	.06682	.06541
45	.07642	.07476	.07316	.07162	.07013
46	.08174	.08000	.07832	.07670	.07514
47	.08736	.08553	.08377	.08207	.08042
48	.09331	.09140	.08955	.08776	.08604
49	.09959	.09759	.09565	.09378	.09198
50	.10624	.10414	.10212	.10016	.09827
51	.11322	.11104	.10892	.10688	.10490
52	.12057	.11829	.11608	.11395	.11188
53	.12827	.12590	.12360	.12138	.11922
54	.13631	.13384	.13145	.12913	.12689
55	.14469	.14213	.13964	.13724	.13490
56	.15341	.15075	.14817	.14567	.14324
57	.16250	.15975	.15708	.15448	.15196
58	.17196	.16911	.16634	.16365	.16104
59	.18183	.17888	.17602	.17324	.17053
60	.19210	.18906	.18611	.18323	.18043
61	.20283	.19970	.19665	.19368	.19079
62	.21402	.21079	.20766	.20460	.20162
63	.22568	.22237	.21914	.21600	.21293
64	.23780	.23440	.23109	.22786	.22471
65	.25038	.24690	.24350	.24019	.23695
66	.26342	.25986	.25638	.25298	.24967
67	.27689	.27325	.26970	.26623	.26284
68	.29081	.28711	.28248	.27994	.27647
69	.30523	.30145	.29776	.29415	.29062
70	.32015	.31632	.31257	.30890	.30530
71	.33568	.33179	.32799	.32426	.32061
72	.35182	.34789	.34404	.34027	.33657
73	.36851	.36455	.36066	.35685	.35311
74	.38555	.38156	.37765	.37381	.37004
75	.40278	.39877	.39484	.39098	.38710
76	.42010	.41608	.41213	.40826	.40445
77	.43746	.43344	.42949	.42561	.42179
78	.45489	.45088	.44693	.44305	.43923
79	.47248	.46848	.46454	.46067	.45686
80	.49028	.48631	.48240	.47854	.47475
82	.50818	.50423	.50035	.49653	.59276
82	.52600	.52210	.51826	.51447	.51074
83	.54377	.53992	.53613	.53238	.52869

TABLE G—Continued

Table G—Single Life, Unisex—Table Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Applicable for Transfers After November 30, 1983, and Before May 1, 1989

(1) Age	(2) Yearly rate of return				
	13.2%	13.4%	13.6%	13.8%	14.0%
84	.56160	.55781	.55407	.55038	.54674
85	.57956	.57584	.57216	.56854	.56496
86	.59717	.59353	.58993	.58638	.58287
87	.61385	.61028	.60676	.60328	.59984
88	.62950	.62601	.62256	.61915	.61578
89	.64445	.64104	.63767	.63434	.63105
90	.65920	.65588	.65259	.64934	.64612
91	.67362	.67039	.66719	.66402	.66089
92	.68720	.68405	.68094	.67786	.67481
93	.69962	.69657	.69354	.69054	.68757
94	.71078	.70780	.70485	.70193	.69903
95	.72053	.71763	.71475	.71189	.70906
96	.72872	.72587	.72305	.72026	.71748
97	.73604	.73325	.73048	.72773	.72501
98	.74239	.73964	.73692	.73422	.73154
99	.74833	.74562	.74294	.74028	.73764
100 ..	.75423	.75156	.74892	.74630	.74370
101 ..	.75928	.75664	.75403	.75144	.74887
102 ..	.76469	.76209	.75950	.75694	.75440
103 ..	.77174	.76918	.76664	.76413	.76163
104 ..	.77824	.77571	.77320	.77071	.76824
105 ..	.78845	.78599	.78354	.78111	.77870
106 ..	.80579	.80346	.80115	.79885	.79657
107 ..	.83070	.82860	.82652	.82444	.82238
108 ..	.87182	.87016	.86852	.86688	.86525
109 ..	.94170	.94092	.94014	.93937	.93860

(e) *Present value of the remainder interest in the case of transfers to pooled income funds for which the valuation date is after April 30, 1989, and before May 1, 1999*—(1) *In general.* In the case of transfers to pooled income funds for which the valuation date is after April 30, 1989, and before May 1, 1999, the present value of a remainder interest is determined under this section. See, however, § 1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). The present value of a remainder interest that is dependent on the termination of the life of one individual is computed by the use of Table S in paragraph (e)(5) of this section. For purposes of the computations under this section, the age of an individual is the age at the individual's nearest birthday. If the valuation date of a transfer to a pooled income fund is after April 30, 1989, and before June 10, 1994, a transferor can rely on Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700, in valuing the transferred interest. (See § 601.601(d)(2)(ii)(*b*) of this chapter.)

(2) *Present value of a remainder interest.* The present value of a remainder interest in property transferred to a pooled income fund is computed on the basis of—

(i) Life contingencies determined from the values of *lx* that are set forth in Table 80CNSMT in § 20.2031–7A(e)(4) of this chapter (Estate Tax Regulations); and

(ii) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. The provisions of § 1.642(c)-6(c) apply for determining the yearly rate of return. However, where the taxable year is less than 12 months, the provisions of § 1.642(c)-6(e)(3)(ii) apply for the determining the yearly rate of return.

(3) *Pooled income funds in existence less than 3 taxable years.* The provisions of § 1.642(c)-6(e)(4) apply for determining the highest yearly rate of return when the pooled income fund has been in existence less than three taxable years.

(4) *Computation of value of remainder interest.* The factor that is used in determining the present value of a remainder interest that is dependent on the termination of the life of one individual is the factor from Table S in paragraph (e)(5) of this section under the appropriate yearly rate of return opposite the number that corresponds to the age of the individual upon whose life the value of the remainder interest is based. Table S in paragraph (e)(5) of this section includes factors for yearly rates of return from 4.2 to 14 percent. Many actuarial factors not contained in Table S in paragraph (e)(5) of this section are contained in Table S in Internal Revenue Service Publication 1457, ''Actuarial Values, Alpha Volume,'' (8–89). Publication 1457 is no longer available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. However, pertinent factors in this publication may be obtained by a written request to: CC:DOM:CORP:R (IRS Publication 1457), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. For other situations, see § 1.642(c)-6(b). If the yearly rate of return is a percentage

that is between the yearly rates of return for which factors are provided, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the fair market value of the property on the valuation date by the appropriate remainder factor. For an example of a computation of the present value of a remainder interest requiring a linear interpolation adjustment, see §1.642(c)-6(e)(5).

(5) *Actuarial tables.* In the case of transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, the present value of a remainder interest dependent on the termination of one life in the case of a transfer to a pooled income fund is determined by use of the following tables:

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
0	.07389	.06749	.06188	.05695	.05261	.04879	.04541	.04243	.03978	.03744
1	.06494	.05832	.05250	.04738	.04287	.03889	.03537	.03226	.02950	.02705
2	.06678	.05999	.05401	.04874	.04410	.03999	.03636	.03314	.03028	.02773
3	.06897	.06200	.05587	.05045	.04567	.04143	.03768	.03435	.03139	.02875
4	.07139	.06425	.05796	.05239	.04746	.04310	.03922	.03578	.03271	.02998
5	.07401	.06669	.06023	.05451	.04944	.04494	.04094	.03738	.03421	.03137
6	.07677	.06928	.06265	.05677	.05156	.04692	.04279	.03911	.03583	.03289
7	.07968	.07201	.06521	.05918	.05381	.04903	.04477	.04097	.03757	.03453
8	.08274	.07489	.06792	.06172	.05621	.05129	.04689	.04297	.03945	.03630
9	.08597	.07794	.07079	.06443	.05876	.05370	.04917	.04511	.04148	.03821
10	.08936	.08115	.07383	.06730	.06147	.05626	.05159	.04741	.04365	.04027
11	.09293	.08453	.07704	.07035	.06436	.05900	.05419	.04988	.04599	.04250
12	.09666	.08807	.08040	.07354	.06739	.06188	.05693	.05248	.04847	.04486
13	.10049	.09172	.08387	.07684	.07053	.06487	.05977	.05518	.05104	.04731
14	.10437	.09541	.08738	.08017	.07370	.06788	.06263	.05791	.05364	.04978
15	.10827	.09912	.09090	.08352	.07688	.07090	.06551	.06064	.05623	.05225
16	.11220	.10285	.09445	.08689	.08008	.07394	.06839	.06337	.05883	.05472
17	.11615	.10661	.09802	.09028	.08330	.07699	.07129	.06612	.06144	.05719
18	.12017	.11043	.10165	.09373	.08656	.08009	.07422	.06890	.06408	.05969
19	.12428	.11434	.10537	.09726	.08992	.08327	.07724	.07177	.06679	.06226
20	.12850	.11836	.10919	.10089	.09337	.08654	.08035	.07471	.06959	.06492
21	.13282	.12248	.11311	.10462	.09692	.08991	.08355	.07775	.07247	.06765
22	.13728	.12673	.11717	.10848	.10059	.09341	.08686	.08090	.07546	.07049
23	.14188	.13113	.12136	.11248	.10440	.09703	.09032	.08418	.07858	.07345
24	.14667	.13572	.12575	.11667	.10839	.10084	.09395	.08764	.08187	.07659
25	.15167	.14051	.13034	.12106	.11259	.10486	.09778	.09130	.08536	.07991
26	.15690	.14554	.13517	.12569	.11703	.10910	.10184	.09518	.08907	.08346
27	.16237	.15081	.14024	.13056	.12171	.11359	.10614	.09930	.09302	.08724
28	.16808	.15632	.14555	.13567	.12662	.11831	.11068	.10366	.09720	.09125
29	.17404	.16208	.15110	.14104	.13179	.12329	.11547	.10827	.10163	.09551
30	.18025	.16808	.15692	.14665	.13721	.12852	.12051	.11313	.10631	.10002
31	.18672	.17436	.16300	.15255	.14291	.13403	.12584	.11827	.11127	.10480
32	.19344	.18090	.16935	.15870	.14888	.13980	.13142	.12367	.11650	.10985
33	.20044	.18772	.17598	.16514	.15513	.14587	.13730	.12936	.12201	.11519
34	.20770	.19480	.18287	.17185	.16165	.15221	.14345	.13533	.12780	.12080
35	.21522	.20215	.19005	.17884	.16846	.15883	.14989	.14159	.13388	.12670
36	.22299	.20974	.19747	.18609	.17552	.16571	.15660	.14812	.14022	.13287
37	.23101	.21760	.20516	.19360	.18286	.17288	.16358	.15492	.14685	.13933
38	.23928	.22572	.21311	.20139	.19048	.18032	.17085	.16201	.15377	.14607
39	.24780	.23409	.22133	.20945	.19837	.18804	.17840	.16939	.16097	.15310
40	.25658	.24273	.22982	.21778	.20654	.19605	.18624	.17706	.16847	.16043
41	.26560	.25163	.23858	.22639	.21499	.20434	.19436	.18502	.17627	.16806
42	.27486	.26076	.24758	.23525	.22370	.21289	.20276	.19326	.18434	.17597
43	.28435	.27013	.25683	.24436	.23268	.22172	.21143	.20177	.19270	.18416
44	.29407	.27975	.26633	.25373	.24191	.23081	.22038	.21057	.20134	.19265
45	.30402	.28961	.27608	.26337	.25142	.24019	.22962	.21966	.21028	.20144
46	.31420	.29970	.28608	.27326	.26120	.24983	.23913	.22904	.21951	.21053
47	.32460	.31004	.29632	.28341	.27123	.25975	.24892	.23870	.22904	.21991
48	.33521	.32058	.30679	.29379	.28151	.26992	.25897	.24862	.23883	.22957
49	.34599	.33132	.31746	.30438	.29201	.28032	.26926	.25879	.24888	.23949
50	.35695	.34224	.32833	.31518	.30273	.29094	.27978	.26921	.25918	.24966
51	.36809	.35335	.33940	.32619	.31367	.30180	.29055	.27987	.26973	.26010
52	.37944	.36468	.35070	.33744	.32486	.31292	.30158	.29081	.28057	.27083
53	.39098	.37622	.36222	.34892	.33629	.32429	.31288	.30203	.29170	.28186
54	.40269	.38794	.37393	.36062	.34795	.33590	.32442	.31349	.30308	.29316
55	.41457	.39985	.38585	.37252	.35983	.34774	.33621	.32522	.31474	.30473

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
56	.42662	.41194	.39796	.38464	.37193	.35981	.34824	.33720	.32666	.31658
57	.43884	.42422	.41028	.39697	.38426	.37213	.36053	.34945	.33885	.32872
58	.45123	.43668	.42279	.40951	.39682	.38468	.37307	.36196	.35132	.34114
59	.46377	.44931	.43547	.42224	.40958	.39745	.38584	.37471	.36405	.35383
60	.47643	.46206	.44830	.43513	.42250	.41040	.39880	.38767	.37699	.36674
61	.48916	.47491	.46124	.44814	.43556	.42350	.41192	.40080	.39012	.37985
62	.50196	.48783	.47427	.46124	.44874	.43672	.42518	.41408	.40340	.39314
63	.51480	.50081	.48736	.47444	.46201	.45006	.43856	.42749	.41684	.40658
64	.52770	.51386	.50054	.48773	.47540	.46352	.45208	.44105	.43043	.42019
65	.54069	.52701	.51384	.50115	.48892	.47713	.46577	.45480	.44422	.43401
66	.55378	.54029	.52727	.51472	.50262	.49093	.47965	.46876	.45824	.44808
67	.56697	.55368	.54084	.52845	.51648	.50491	.49373	.48293	.47248	.46238
68	.58026	.56717	.55453	.54231	.53049	.51905	.50800	.49729	.48694	.47691
69	.59358	.58072	.56828	.55624	.54459	.53330	.52238	.51179	.50154	.49160
70	.60689	.59427	.58205	.57021	.55874	.54762	.53683	.52638	.51624	.50641
71	.62014	.60778	.59578	.58415	.57287	.56193	.55131	.54100	.53099	.52126
72	.63334	.62123	.60948	.59808	.58700	.57624	.56579	.55563	.54577	.53617
73	.64648	.63465	.62315	.61198	.60112	.59056	.58029	.57030	.56059	.55113
74	.65961	.64806	.63682	.62590	.61527	.60492	.59485	.58504	.57550	.56620
75	.67274	.66149	.65054	.63987	.62948	.61936	.60950	.59990	.59053	.58140
76	.68589	.67495	.66429	.65390	.64377	.63390	.62427	.61487	.60570	.59676
77	.69903	.68841	.67806	.66796	.65811	.64849	.63910	.62993	.62097	.61223
78	.71209	.70182	.69179	.68199	.67242	.66307	.65393	.64501	.63628	.62775
79	.72500	.71507	.70537	.69588	.68660	.67754	.66867	.65999	.65151	.64321
80	.73768	.72809	.71872	.70955	.70058	.69180	.68320	.67479	.66655	.65849
81	.75001	.74077	.73173	.72288	.71422	.70573	.69741	.68926	.68128	.67345
82	.76195	.75306	.74435	.73582	.72746	.71926	.71123	.70335	.69562	.68804
83	.77346	.76491	.75654	.74832	.74026	.73236	.72460	.71699	.70952	.70219
84	.78456	.77636	.76831	.76041	.75265	.74503	.73756	.73021	.72300	.71592
85	.79530	.78743	.77971	.77212	.76466	.75733	.75014	.74306	.73611	.72928
86	.80560	.79806	.79065	.78337	.77621	.76917	.76225	.75544	.74875	.74216
87	.81535	.80813	.80103	.79404	.78717	.78041	.77375	.76720	.76076	.75442
88	.82462	.81771	.81090	.80420	.79760	.79111	.78472	.77842	.77223	.76612
89	.83356	.82694	.82043	.81401	.80769	.80147	.79533	.78929	.78334	.77747
90	.84225	.83593	.82971	.82357	.81753	.81157	.80570	.79991	.79420	.78857
91	.85058	.84455	.83861	.83276	.82698	.82129	.81567	.81013	.80466	.79927
92	.85838	.85263	.84696	.84137	.83585	.83040	.82503	.81973	.81449	.80933
93	.86557	.86009	.85467	.84932	.84405	.83884	.83370	.82862	.82360	.81865
94	.87212	.86687	.86169	.85657	.85152	.84653	.84160	.83673	.83192	.82717
95	.87801	.87298	.86801	.86310	.85825	.85345	.84872	.84404	.83941	.83484
96	.88322	.87838	.87360	.86888	.86420	.85959	.85502	.85051	.84605	.84165
97	.88795	.88328	.87867	.87411	.86961	.86515	.86074	.85639	.85208	.84782
98	.89220	.88769	.88323	.87883	.87447	.87016	.86589	.86167	.85750	.85337
99	.89612	.89176	.88745	.88318	.87895	.87478	.87064	.86656	.86251	.85850
100	.89977	.89555	.89136	.88722	.88313	.87908	.87506	.87109	.86716	.86327
101	.90326	.89917	.89511	.89110	.88712	.88318	.87929	.87543	.87161	.86783
102	.90690	.90294	.89901	.89513	.89128	.88746	.88369	.87995	.87624	.87257
103	.91076	.90694	.90315	.89940	.89569	.89200	.88835	.88474	.88116	.87760
104	.91504	.91138	.90775	.90415	.90058	.89704	.89354	.89006	.88661	.88319
105	.92027	.91681	.91337	.90996	.90658	.90322	.89989	.89659	.89331	.89006
106	.92763	.92445	.92130	.91816	.91506	.91197	.90890	.90586	.90284	.89983
107	.93799	.93523	.93249	.92977	.92707	.92438	.92170	.91905	.91641	.91378
108	.95429	.95223	.95018	.94814	.94611	.94409	.94208	.94008	.93809	.93611
109	.97985	.97893	.97801	.97710	.97619	.97529	.97438	.97348	.97259	.97170

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03535	.03349	.03183	.03035	.02902	.02783	.02676	.02579	.02492	.02413
1	.02486	.02292	.02119	.01963	.01824	.01699	.01587	.01486	.01395	.01312
2	.02547	.02345	.02164	.02002	.01857	.01727	.01609	.01504	.01408	.01321
3	.02640	.02429	.02241	.02073	.01921	.01785	.01662	.01552	.01451	.01361
4	.02753	.02535	.02339	.02163	.02005	.01863	.01735	.01619	.01514	.01418
5	.02883	.02656	.02453	.02269	.02105	.01956	.01822	.01700	.01590	.01490

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
6	.03026	.02790	.02578	.02387	.02215	.02060	.01919	.01792	.01677	.01572
7	.03180	.02935	.02714	.02515	.02336	.02174	.02027	.01894	.01773	.01664
8	.03347	.03092	.02863	.02656	.02469	.02300	.02146	.02007	.01881	.01766
9	.03528	.03263	.03025	.02810	.02615	.02438	.02278	.02133	.02000	.01880
10	.03723	.03449	.03201	.02977	.02774	.02590	.02423	.02271	.02133	.02006
11	.03935	.03650	.03393	.03160	.02949	.02757	.02583	.02424	.02279	.02147
12	.04160	.03865	.03598	.03356	.03136	.02936	.02755	.02589	.02438	.02299
13	.04394	.04088	.03811	.03560	.03331	.03123	.02934	.02761	.02603	.02458
14	.04629	.04312	.04025	.03764	.03527	.03311	.03113	.02933	.02768	.02617
15	.04864	.04536	.04238	.03968	.03721	.03496	.03290	.03103	.02930	.02773
16	.05099	.04759	.04451	.04170	.03913	.03679	.03466	.03270	.03090	.02926
17	.05333	.04982	.04662	.04370	.04104	.03861	.03638	.03434	.03247	.03075
18	.05570	.05207	.04875	.04573	.04296	.04044	.03812	.03599	.03404	.03225
19	.05814	.05438	.05095	.04781	.04494	.04231	.03990	.03769	.03565	.03378
20	.06065	.05677	.05321	.04996	.04698	.04424	.04173	.03943	.03731	.03535
21	.06325	.05922	.05554	.05217	.04907	.04623	.04362	.04122	.03901	.03697
22	.06594	.06178	.05797	.05447	.05126	.04831	.04559	.04309	.04078	.03865
23	.06876	.06446	.06051	.05688	.05355	.05048	.04766	.04505	.04265	.04042
24	.07174	.06729	.06321	.05945	.05599	.05281	.04987	.04715	.04465	.04233
25	.07491	.07031	.06609	.06219	.05861	.05530	.05224	.04941	.04680	.04438
26	.07830	.07355	.06918	.06515	.06142	.05799	.05481	.05187	.04915	.04662
27	.08192	.07702	.07250	.06832	.06446	.06090	.05759	.05454	.05170	.04906
28	.08577	.08071	.07603	.07171	.06772	.06402	.06059	.05740	.05445	.05170
29	.08986	.08464	.07981	.07534	.07120	.06736	.06380	.06049	.05742	.05456
30	.09420	.08882	.08383	.07921	.07492	.07095	.06725	.06381	.06061	.05763
31	.09881	.09327	.08812	.08335	.07891	.07479	.07095	.06738	.06405	.06095
32	.10369	.09797	.09267	.08774	.08315	.07888	.07491	.07120	.06774	.06451
33	.10885	.10297	.09750	.09241	.08767	.08325	.07913	.07529	.07170	.06834
34	.11430	.10824	.10261	.09736	.09246	.08790	.08363	.07964	.07592	.07243
35	.12002	.11380	.10800	.10259	.09754	.09282	.08841	.08428	.08041	.07679
36	.12602	.11963	.11366	.10809	.10288	.09800	.09344	.08917	.08516	.08140
37	.13230	.12574	.11961	.11387	.10850	.10347	.09876	.09433	.09018	.08628
38	.13887	.13214	.12584	.11994	.11441	.10922	.10436	.09978	.09549	.09145
39	.14573	.13883	.13237	.12630	.12061	.11527	.11025	.10553	.10109	.09690
40	.15290	.14583	.13920	.13297	.12712	.12162	.11644	.11157	.10698	.10266
41	.16036	.15312	.14633	.13994	.13393	.12827	.12294	.11792	.11318	.10871
42	.16810	.16071	.15375	.14720	.14103	.13522	.12973	.12456	.11967	.11505
43	.17614	.16858	.16146	.15475	.14842	.14245	.13682	.13149	.12645	.12169
44	.18447	.17675	.16948	.16261	.15613	.15000	.14421	.13873	.13355	.12864
45	.19310	.18524	.17780	.17078	.16414	.15787	.15192	.14630	.14096	.13591
46	.20204	.19402	.18644	.17926	.17247	.16604	.15995	.15418	.14870	.14350
47	.21128	.20311	.19538	.18806	.18112	.17454	.16830	.16238	.15676	.15141
48	.22080	.21249	.20462	.19716	.19007	.18335	.17696	.17090	.16513	.15964
49	.23059	.22214	.21413	.20653	.19930	.19244	.18591	.17970	.17379	.16816
50	.24063	.23206	.22391	.21617	.20881	.20180	.19514	.18879	.18274	.17697
51	.25095	.24225	.23398	.22610	.21861	.21147	.20466	.19818	.19199	.18609
52	.26157	.25275	.24436	.23636	.22874	.22147	.21453	.20791	.20159	.19556
53	.27249	.26357	.25505	.24694	.23919	.23180	.22474	.21799	.21154	.20537
54	.28369	.27466	.26604	.25782	.24995	.24244	.23526	.22839	.22181	.21552
55	.29518	.28605	.27734	.26900	.26103	.25341	.24611	.23912	.23243	.22601
56	.30695	.29774	.28893	.28050	.27242	.26469	.25728	.25019	.24338	.23685
57	.31902	.30973	.30084	.29232	.28415	.27632	.26881	.26161	.25469	.24805
58	.33138	.32203	.31306	.30446	.29621	.28829	.28069	.27339	.26637	.25962
59	.34402	.33461	.32558	.31691	.30859	.30059	.29290	.28550	.27839	.27155
60	.35690	.34745	.33836	.32963	.32124	.31317	.30540	.29792	.29073	.28379
61	.36999	.36050	.35137	.34259	.33414	.32601	.31817	.31062	.30334	.29633
62	.38325	.37374	.36458	.35576	.34726	.33907	.33117	.32356	.31621	.30912
63	.39669	.38717	.37799	.36913	.36060	.35236	.34441	.33674	.32933	.32217
64	.41031	.40078	.39159	.38272	.37415	.36588	.35789	.35016	.34270	.33548
65	.42416	.41464	.40545	.39656	.38798	.37968	.37166	.36390	.35639	.34912
66	.43825	.42876	.41958	.41070	.40211	.39380	.38576	.37797	.37043	.36312
67	.45260	.44315	.43399	.42513	.41655	.40824	.40019	.39238	.38482	.37749
68	.46720	.45779	.44868	.43985	.43129	.42299	.41494	.40713	.39956	.39221
69	.48197	.47263	.46357	.45478	.44625	.43798	.42995	.42215	.41458	.40722
70	.49686	.48760	.47861	.46988	.46140	.45316	.44516	.43738	.42983	.42248
71	.51182	.50265	.49374	.48508	.47666	.46847	.46051	.45276	.44523	.43790
72	.52685	.51778	.50896	.50038	.49203	.48390	.47599	.46829	.46079	.45349
73	.54194	.53298	.52426	.51578	.50751	.49946	.49161	.48397	.47652	.46926
74	.55714	.54832	.53972	.53134	.52317	.51520	.50744	.49986	.49247	.48527

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
75	.57250	.56382	.55536	.54710	.53904	.53118	.52351	.51601	.50870	.50156
76	.58803	.57951	.57120	.56308	.55515	.54740	.53984	.53245	.52522	.51817
77	.60369	.59535	.58720	.57923	.57144	.56383	.55639	.54912	.54200	.53504
78	.61942	.61126	.60329	.59549	.58787	.58040	.57310	.56596	.55896	.55212
79	.63508	.62713	.61935	.61174	.60428	.59698	.58983	.58283	.57597	.56925
80	.65059	.64285	.63527	.62785	.62058	.61345	.60646	.59961	.59290	.58632
81	.66579	.65827	.65090	.64368	.63659	.62965	.62283	.61615	.60959	.60316
82	.68061	.67332	.66616	.65914	.65226	.64550	.63886	.63235	.62595	.61968
83	.69499	.68793	.68099	.67418	.66749	.66092	.65447	.64813	.64191	.63579
84	.70896	.70213	.69541	.68881	.68233	.67595	.66969	.66353	.65748	.65153
85	.72256	.71596	.70947	.70308	.69681	.69063	.68456	.67859	.67271	.66693
86	.73569	.72931	.72305	.71688	.71081	.70484	.69896	.69318	.68748	.68188
87	.74818	.74204	.73599	.73003	.72417	.71839	.71271	.70711	.70159	.69616
88	.76011	.75419	.74836	.74261	.73695	.73137	.72588	.72046	.71512	.70986
89	.77169	.76599	.76037	.75484	.74938	.74400	.73870	.73347	.72831	.72323
90	.78302	.77755	.77215	.76683	.76158	.75640	.75129	.74625	.74128	.73638
91	.79395	.78870	.78352	.77842	.77337	.76840	.76349	.75864	.75385	.74913
92	.80423	.79920	.79423	.78933	.78449	.77971	.77499	.77033	.76572	.76118
93	.81377	.80894	.80417	.79946	.79481	.79022	.78568	.78120	.77677	.77239
94	.82247	.81784	.81325	.80873	.80425	.79983	.79547	.79115	.78688	.78266
95	.83033	.82586	.82145	.81709	.81278	.80852	.80431	.80014	.79602	.79195
96	.83729	.83298	.82872	.82451	.82034	.81622	.81215	.80812	.80414	.80019
97	.84361	.83944	.83532	.83124	.82721	.82322	.81927	.81537	.81151	.80769
98	.84929	.84525	.84126	.83730	.83339	.82952	.82569	.82190	.81815	.81443
99	.85454	.85062	.84674	.84290	.83910	.83534	.83161	.82792	.82427	.82066
100	.85942	.85561	.85184	.84810	.84440	.84074	.83711	.83352	.82997	.82644
101	.86408	.86037	.85670	.85306	.84946	.84589	.84236	.83886	.83539	.83196
102	.86894	.86534	.86177	.85823	.85473	.85126	.84782	.84442	.84104	.83770
103	.87408	.87060	.86714	.86371	.86032	.85695	.85362	.85031	.84703	.84378
104	.87980	.87644	.87311	.86980	.86653	.86328	.86005	.85686	.85369	.85054
105	.88684	.88363	.88046	.87731	.87418	.87108	.86800	.86494	.86191	.85890
106	.89685	.89389	.89095	.88804	.88514	.88226	.87940	.87656	.87374	.87094
107	.91117	.90858	.90600	.90344	.90089	.89836	.89584	.89334	.89085	.88838
108	.93414	.93217	.93022	.92828	.92634	.92442	.92250	.92060	.91870	.91681
109	.97081	.96992	.96904	.96816	.96729	.96642	.96555	.96468	.96382	.96296

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02341	.02276	.02217	.02163	.02114	.02069	.02027	.01989	.01954	.01922
1	.01237	.01170	.01108	.01052	.01000	.00953	.00910	.00871	.00834	.00801
2	.01243	.01172	.01107	.01048	.00994	.00944	.00899	.00857	.00819	.00784
3	.01278	.01203	.01135	.01073	.01016	.00964	.00916	.00872	.00832	.00795
4	.01332	.01253	.01182	.01116	.01056	.01001	.00951	.00904	.00862	.00822
5	.01400	.01317	.01241	.01172	.01109	.01051	.00998	.00949	.00904	.00862
6	.01477	.01390	.01310	.01238	.01171	.01110	.01054	.01002	.00954	.00910
7	.01563	.01472	.01389	.01312	.01242	.01178	.01118	.01064	.01013	.00966
8	.01660	.01564	.01477	.01396	.01322	.01254	.01192	.01134	.01081	.01031
9	.01770	.01669	.01577	.01492	.01414	.01342	.01276	.01216	.01159	.01107
10	.01891	.01785	.01688	.01599	.01517	.01442	.01372	.01308	.01249	.01194
11	.02026	.01915	.01814	.01720	.01634	.01555	.01481	.01414	.01351	.01293
12	.02173	.02056	.01950	.01852	.01761	.01678	.01601	.01529	.01463	.01402
13	.02326	.02204	.02092	.01989	.01895	.01807	.01726	.01651	.01582	.01517
14	.02478	.02351	.02234	.02126	.02027	.01935	.01850	.01771	.01698	.01630
15	.02628	.02495	.02372	.02259	.02155	.02058	.01969	.01886	.01810	.01738
16	.02774	.02635	.02507	.02388	.02279	.02178	.02084	.01997	.01917	.01842
17	.02917	.02772	.02637	.02513	.02399	.02293	.02194	.02103	.02018	.01940
18	.03059	.02907	.02767	.02637	.02517	.02406	.02302	.02207	.02118	.02035
19	.03205	.03046	.02899	.02763	.02637	.02521	.02412	.02312	.02218	.02131
20	.03355	.03188	.03035	.02892	.02760	.02638	.02524	.02419	.02320	.02229
21	.03509	.03334	.03173	.03024	.02886	.02758	.02638	.02527	.02424	.02328
22	.03669	.03487	.03318	.03162	.03017	.02882	.02757	.02640	.02532	.02430
23	.03837	.03646	.03470	.03306	.03154	.03013	.02881	.02759	.02644	.02538
24	.04018	.03819	.03634	.03463	.03303	.03155	.03016	.02888	.02767	.02655

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
25	.04214	.04006	.03812	.03633	.03465	.03309	.03164	.03029	.02902	.02784
26	.04428	.04210	.04008	.03820	.03644	.03481	.03328	.03186	.03052	.02928
27	.04662	.04434	.04223	.04025	.03841	.03670	.03509	.03360	.03219	.03088
28	.04915	.04677	.04456	.04249	.04056	.03876	.03708	.03550	.03403	.03264
29	.05189	.04941	.04709	.04493	.04291	.04102	.03925	.03760	.03604	.03458
30	.05485	.05226	.04984	.04757	.04546	.04348	.04162	.03988	.03825	.03671
31	.05805	.05535	.05282	.05045	.04824	.04616	.04421	.04238	.04067	.03905
32	.06149	.05867	.05603	.05356	.05124	.04906	.04702	.04510	.04329	.04160
33	.06520	.06226	.05950	.05692	.05449	.05221	.05007	.04806	.04616	.04438
34	.06916	.06609	.06322	.06052	.05799	.05560	.05336	.05125	.04926	.04738
35	.07339	.07020	.06720	.06439	.06174	.05925	.05690	.05469	.05260	.05063
36	.07787	.07455	.07143	.06850	.06573	.06313	.06068	.05836	.05617	.05411
37	.08262	.07917	.07593	.07287	.06999	.06727	.06470	.06228	.05999	.05783
38	.08765	.08407	.08069	.07751	.07451	.07167	.06899	.06646	.06407	.06180
39	.09296	.08925	.08574	.08243	.07931	.07635	.07356	.07092	.06841	.06604
40	.09858	.09472	.09109	.08765	.08440	.08132	.07841	.07565	.07303	.07055
41	.10449	.10050	.09673	.09316	.08978	.08658	.08355	.08067	.07794	.07535
42	.11069	.10656	.10265	.09895	.09544	.09212	.08896	.08596	.08312	.08041
43	.11718	.11291	.10887	.10503	.10140	.09794	.09466	.09154	.08858	.08576
44	.12399	.11958	.11540	.11143	.10766	.10407	.10067	.09743	.09434	.09141
45	.13111	.12656	.12224	.11814	.11423	.11052	.10699	.10362	.10042	.09736
46	.13856	.13387	.12941	.12516	.12113	.11728	.11362	.11013	.10680	.10363
47	.14633	.14150	.13690	.13252	.12835	.12438	.12059	.11697	.11352	.11022
48	.15442	.14945	.14471	.14020	.13589	.13179	.12787	.12412	.12055	.11713
49	.16280	.15769	.15281	.14816	.14373	.13949	.13544	.13157	.12787	.12433
50	.17147	.16622	.16121	.15643	.15186	.14749	.14331	.13931	.13548	.13182
51	.18045	.17507	.16993	.16501	.16030	.15580	.15150	.14737	.14342	.13963
52	.18979	.18427	.17899	.17394	.16911	.16448	.16004	.15579	.15172	.14780
53	.19947	.19383	.18842	.18324	.17828	.17352	.16896	.16458	.16038	.15635
54	.20950	.20372	.19819	.19288	.18779	.18291	.17822	.17372	.16940	.16524
55	.21986	.21397	.20831	.20288	.19767	.19266	.18785	.18322	.17878	.17450
56	.23058	.22457	.21879	.21324	.20791	.20278	.19785	.19310	.18854	.18414
57	.24167	.23554	.22965	.22399	.21854	.21329	.20824	.20338	.19870	.19419
58	.25314	.24690	.24090	.23512	.22956	.22420	.21904	.21407	.20927	.20464
59	.26497	.25863	.25252	.24664	.24097	.23550	.23023	.22515	.22024	.21551
60	.27712	.27068	.26448	.25849	.25272	.24716	.24178	.23659	.23158	.22674
61	.28956	.28304	.27674	.27067	.26480	.25913	.25366	.24837	.24325	.23831
62	.30228	.29567	.28929	.28312	.27717	.27141	.26584	.26045	.25524	.25020
63	.31525	.30857	.30211	.29586	.28982	.28397	.27832	.27284	.26754	.26240
64	.32851	.32176	.31522	.30890	.30278	.29685	.29111	.28555	.28016	.27493
65	.34209	.33528	.32868	.32229	.31610	.31010	.30429	.29865	.29317	.28787
66	.35604	.34918	.34253	.33609	.32983	.32377	.31788	.31217	.30663	.30124
67	.37037	.36347	.35678	.35028	.34398	.33786	.33191	.32614	.32053	.31508
68	.38508	.37815	.37142	.36489	.35854	.35237	.34638	.34055	.33488	.32937
69	.40008	.39313	.38638	.37982	.37344	.36724	.36120	.35533	.34961	.34405
70	.41533	.40838	.40162	.39504	.38864	.38241	.37634	.37043	.36468	.35907
71	.43076	.42382	.41705	.41047	.40405	.39780	.39171	.38578	.38000	.37436
72	.44638	.43945	.43269	.42611	.41969	.41344	.40733	.40138	.39558	.38991
73	.46218	.45527	.44854	.44197	.43556	.42931	.42321	.41725	.41143	.40575
74	.47823	.47137	.46466	.45812	.45173	.44549	.43940	.43345	.42763	.42195
75	.49459	.48777	.48112	.47462	.46826	.46205	.45598	.45004	.44424	.43856
76	.51127	.50452	.49793	.49148	.48517	.47900	.47297	.46706	.46129	.45563
77	.52823	.52157	.51505	.50867	.50243	.49632	.49033	.48447	.47873	.47311
78	.54541	.53885	.53242	.52613	.51996	.51392	.50800	.50220	.49652	.49094
79	.56267	.55621	.54989	.54369	.53762	.53166	.52582	.52009	.51448	.50897
80	.57987	.57354	.56733	.56125	.55527	.54941	.54366	.53802	.53248	.52705
81	.59685	.59065	.58457	.57860	.57274	.56699	.56134	.55579	.55035	.54499
82	.61351	.60746	.60151	.59567	.58993	.58429	.57875	.57331	.56796	.56270
83	.62978	.62387	.61806	.61236	.60675	.60123	.59581	.59047	.58523	.58007
84	.64567	.63992	.63426	.62869	.62321	.61783	.61253	.60731	.60218	.59713
85	.66125	.65565	.65014	.64472	.63938	.63413	.62896	.62387	.61886	.61392
86	.67636	.67092	.66557	.66030	.65511	.65000	.64496	.64000	.63511	.63030
87	.69081	.68554	.68034	.67522	.67018	.66520	.66031	.65548	.65071	.64602
88	.70468	.69957	.69453	.68956	.68466	.67983	.67507	.67037	.66574	.66117
89	.71821	.71326	.70838	.70357	.69882	.69414	.68952	.68495	.68045	.67601
90	.73153	.72676	.72204	.71739	.71280	.70827	.70379	.69938	.69502	.69071
91	.74447	.73986	.73532	.73083	.72640	.72202	.71770	.71343	.70921	.70504
92	.75669	.75225	.74787	.74354	.73927	.73504	.73087	.72674	.72267	.71864
93	.76807	.76379	.75957	.75540	.75127	.74719	.74317	.73918	.73524	.73135

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
94	.77849	.77437	.77030	.76627	.76229	.75835	.75446	.75061	.74680	.74303
95	.78792	.78394	.78001	.77611	.77226	.76845	.76468	.76096	.75727	.75362
96	.79630	.79244	.78863	.78485	.78112	.77742	.77377	.77015	.76657	.76303
97	.80391	.80016	.79646	.79280	.78917	.78559	.78203	.77852	.77504	.77160
98	.81076	.80712	.80352	.79996	.79643	.79294	.78948	.78606	.78267	.77931
99	.81709	.81354	.81004	.80657	.80313	.79972	.79635	.79302	.78971	.78644
100	.82296	.81950	.81609	.81270	.80934	.80602	.80273	.79947	.79624	.79304
101	.82855	.82518	.82185	.81854	.81526	.81201	.80880	.80561	.80245	.79932
102	.83438	.83110	.82785	.82462	.82142	.81826	.81512	.81200	.80892	.80586
103	.84056	.83737	.83420	.83106	.82795	.82487	.82181	.81878	.81577	.81279
104	.84743	.84433	.84127	.83822	.83521	.83221	.82924	.82630	.82338	.82048
105	.85591	.85295	.85001	.84709	.84419	.84132	.83846	.83563	.83282	.83003
106	.86816	.86540	.86266	.85993	.85723	.85454	.85187	.84922	.84659	.84397
107	.88592	.88348	.88105	.87863	.87623	.87384	.87147	.86911	.86676	.86443
108	.91493	.91306	.91119	.90934	.90749	.90566	.90383	.90201	.90020	.89840
109	.96211	.96125	.96041	.95956	.95872	.95788	.95704	.95620	.95537	.95455

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989, Before May 1, 1999]

Age	Interest rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
0	.01891	.01864	.01838	.01814	.01791	.01770	.01750	.01732	.01715	.01698
1	.00770	.00741	.00715	.00690	.00667	.00646	.00626	.00608	.00590	.00574
2	.00751	.00721	.00693	.00667	.00643	.00620	.00600	.00580	.00562	.00544
3	.00760	.00728	.00699	.00671	.00646	.00622	.00600	.00579	.00560	.00541
4	.00786	.00752	.00721	.00692	.00665	.00639	.00616	.00594	.00573	.00554
5	.00824	.00788	.00755	.00724	.00695	.00668	.00643	.00620	.00598	.00578
6	.00869	.00832	.00796	.00764	.00733	.00705	.00678	.00654	.00630	.00608
7	.00923	.00883	.00846	.00811	.00779	.00749	.00720	.00694	.00669	.00646
8	.00986	.00943	.00904	.00867	.00833	.00801	.00771	.00743	.00716	.00692
9	.01059	.01014	.00972	.00933	.00897	.00863	.00831	.00801	.00773	.00747
10	.01142	.01095	.01051	.01009	.00971	.00935	.00901	.00869	.00840	.00812
11	.01239	.01189	.01142	.01098	.01057	.01019	.00983	.00950	.00918	.00889
12	.01345	.01292	.01243	.01197	.01154	.01113	.01075	.01040	.01007	.00975
13	.01457	.01401	.01349	.01300	.01255	.01212	.01172	.01135	.01100	.01067
14	.01567	.01508	.01453	.01402	.01354	.01309	.01267	.01227	.01190	.01155
15	.01672	.01610	.01552	.01498	.01448	.01400	.01356	.01314	.01275	.01238
16	.01772	.01707	.01646	.01589	.01536	.01486	.01439	.01396	.01354	.01315
17	.01866	.01798	.01734	.01674	.01618	.01566	.01516	.01470	.01427	.01386
18	.01958	.01886	.01818	.01755	.01697	.01641	.01590	.01541	.01495	.01452
19	.02050	.01974	.01903	.01837	.01775	.01717	.01662	.01611	.01563	.01517
20	.02143	.02064	.01989	.01919	.01854	.01793	.01735	.01681	.01630	.01582
21	.02238	.02154	.02075	.02002	.01933	.01868	.01807	.01750	.01696	.01646
22	.02336	.02247	.02164	.02087	.02014	.01946	.01882	.01821	.01764	.01711
23	.02438	.02345	.02257	.02176	.02099	.02027	.01959	.01895	.01835	.01778
24	.02550	.02451	.02359	.02273	.02192	.02115	.02044	.01976	.01913	.01853
25	.02673	.02569	.02472	.02381	.02295	.02214	.02138	.02067	.01999	.01936
26	.02811	.02701	.02598	.02502	.02411	.02326	.02246	.02170	.02098	.02031
27	.02965	.02849	.02741	.02639	.02543	.02452	.02367	.02287	.02211	.02140
28	.03134	.03013	.02898	.02790	.02689	.02593	.02503	.02418	.02338	.02262
29	.03322	.03193	.03072	.02958	.02851	.02750	.02654	.02564	.02479	.02398
30	.03527	.03391	.03264	.03143	.03030	.02923	.02821	.02726	.02635	.02550
31	.03753	.03610	.03475	.03348	.03228	.03115	.03008	.02907	.02811	.02720
32	.04000	.03849	.03707	.03573	.03446	.03326	.03213	.03105	.03004	.02907
33	.04269	.04111	.03961	.03819	.03685	.03558	.03438	.03325	.03217	.03115
34	.04561	.04394	.04236	.04087	.03946	.03812	.03685	.03565	.03451	.03342
35	.04877	.04702	.04535	.04378	.04229	.04087	.03953	.03826	.03706	.03591
36	.05215	.05031	.04856	.04690	.04533	.04384	.04242	.04108	.03980	.03859
37	.05578	.05384	.05200	.05025	.04860	.04703	.04553	.04411	.04276	.04148
38	.05965	.05761	.05568	.05385	.05211	.05045	.04888	.04738	.04595	.04460
39	.06379	.06165	.05962	.05770	.05587	.05412	.05247	.05089	.04939	.04795
40	.06820	.06596	.06383	.06181	.05989	.05806	.05631	.05465	.05307	.05155
41	.07288	.07054	.06832	.06620	.06418	.06226	.06042	.05868	.05701	.05541
42	.07784	.07539	.07306	.07085	.06873	.06671	.06479	.06295	.06119	.05952
43	.08308	.08052	.07808	.07576	.07355	.07143	.06941	.06748	.06564	.06387

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989, Before May 1, 1999]

Age	Interest rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
44	.08861	.08594	.08340	.08097	.07865	.07644	.07432	.07230	.07036	.06851
45	.09445	.09167	.08901	.08648	.08406	.08174	.07953	.07741	.07538	.07343
46	.10060	.09770	.09494	.09230	.08977	.08735	.08503	.08281	.08068	.07865
47	.10707	.10406	.10119	.09843	.09579	.09327	.09085	.08853	.08630	.08417
48	.11386	.11073	.10774	.10487	.10213	.09949	.09697	.09455	.09222	.08999
49	.12094	.11769	.11458	.11160	.10874	.10600	.10337	.10084	.09842	.09609
50	.12831	.12494	.12172	.11862	.11565	.11280	.11006	.10743	.10490	.10247
51	.13600	.13251	.12917	.12596	.12288	.11991	.11706	.11432	.11169	.10915
52	.14405	.14044	.13698	.13366	.13046	.12738	.12442	.12157	.11883	.11619
53	.15247	.14875	.14517	.14172	.13841	.13522	.13215	.12919	.12635	.12360
54	.16124	.15740	.15370	.15014	.14671	.14341	.14023	.13717	.13421	.13136
55	.17039	.16642	.16261	.15893	.15539	.15198	.14868	.14551	.14244	.13948
56	.17991	.17583	.17190	.16811	.16445	.16092	.15752	.15423	.15106	.14799
57	.18984	.18564	.18160	.17769	.17392	.17029	.16677	.16338	.16010	.15692
58	.20018	.19587	.19172	.18770	.18382	.18007	.17645	.17295	.16956	.16628
59	.21093	.20652	.20225	.19812	.19414	.19028	.18655	.18294	.17945	.17606
60	.22206	.21753	.21316	.20893	.20483	.20087	.19703	.19332	.18972	.18624
61	.23353	.22890	.22442	.22009	.21589	.21182	.20788	.20407	.20037	.19678
62	.24532	.24059	.23601	.23158	.22728	.22311	.21907	.21515	.21135	.20767
63	.25742	.25260	.24793	.24339	.23900	.23473	.23060	.22658	.22268	.21890
64	.26987	.26495	.26019	.25556	.25107	.24671	.24248	.23837	.23438	.23050
65	.28271	.27771	.27286	.26815	.26357	.25912	.25480	.25059	.24651	.24254
66	.29601	.29093	.28600	.28120	.27654	.27200	.26760	.26331	.25913	.25507
67	.30978	.30462	.29961	.29474	.29000	.28539	.28090	.27653	.27227	.26813
68	.32401	.31879	.31371	.30877	.30396	.29927	.29471	.29027	.28593	.28171
69	.33863	.33336	.32822	.32322	.31835	.31359	.30896	.30445	.30005	.29576
70	.35361	.34829	.34310	.33804	.33311	.32830	.32361	.31903	.31457	.31021
71	.36886	.36349	.35826	.35316	.34818	.34332	.33858	.33394	.32942	.32500
72	.38439	.37899	.37373	.36858	.36356	.35866	.35387	.34919	.34461	.34015
73	.40021	.39479	.38950	.38432	.37927	.37433	.36950	.36478	.36016	.35565
74	.41639	.41096	.40565	.40046	.39538	.39042	.38556	.38081	.37616	.37161
75	.43301	.42758	.42226	.41706	.41198	.40699	.40212	.39734	.39267	.38809
76	.45009	.44467	.43937	.43417	.42908	.42410	.41921	.41443	.40974	.40514
77	.46761	.46221	.45693	.45175	.44667	.44170	.43682	.43203	.42734	.42274
78	.48548	.48013	.47488	.46973	.46468	.45972	.45486	.45009	.44541	.44082
79	.50356	.49826	.49306	.48795	.48294	.47802	.47319	.46845	.46379	.45922
80	.52171	.51647	.51133	.50628	.50132	.49644	.49166	.48695	.48233	.47779
81	.53974	.53457	.52950	.52451	.51961	.51479	.51006	.50541	.50083	.49633
82	.55753	.55245	.54745	.54254	.53771	.53296	.52828	.52369	.51917	.51472
83	.57500	.57001	.56510	.56026	.55551	.55083	.54623	.54170	.53724	.53285
84	.59216	.58726	.58245	.57770	.57304	.56844	.56391	.55945	.55506	.55074
85	.60906	.60428	.59956	.59492	.59034	.58583	.58139	.57702	.57270	.56845
86	.62555	.62088	.61627	.61173	.60725	.60284	.59849	.59420	.58997	.58580
87	.64139	.63683	.63233	.62790	.62352	.61921	.61495	.61076	.60661	.60253
88	.65666	.65221	.64783	.64350	.63923	.63502	.63086	.62675	.62270	.61871
89	.67163	.66730	.66304	.65882	.65466	.65055	.64650	.64249	.63854	.63463
90	.68646	.68226	.67812	.67402	.66998	.66599	.66204	.65814	.65430	.65049
91	.70093	.69686	.69285	.68888	.68496	.68108	.67725	.67347	.66973	.66604
92	.71466	.71073	.70684	.70300	.69920	.69545	.69173	.68806	.68444	.68085
93	.72750	.72370	.71994	.71622	.71254	.70890	.70530	.70174	.69822	.69474
94	.73931	.73562	.73198	.72838	.72481	.72129	.71780	.71434	.71093	.70755
95	.75001	.74644	.74291	.73941	.73595	.73253	.72914	.72579	.72247	.71919
96	.75953	.75606	.75262	.74923	.74586	.74253	.73924	.73598	.73275	.72955
97	.76819	.76481	.76147	.75816	.75489	.75165	.74844	.74526	.74211	.73899
98	.77599	.77270	.76944	.76621	.76302	.75986	.75672	.75362	.75054	.74750
99	.78319	.77998	.77680	.77365	.77053	.76744	.76437	.76134	.75833	.75535
100	.78987	.78673	.78362	.78054	.77748	.77446	.77146	.76849	.76555	.76263
101	.79622	.79315	.79010	.78708	.78409	.78113	.77819	.77528	.77239	.76953
102	.80283	.79983	.79685	.79390	.79097	.78807	.78519	.78234	.77951	.77671
103	.80983	.80690	.80399	.80111	.79825	.79541	.79260	.78981	.78705	.78430
104	.81760	.81475	.81192	.80912	.80633	.80357	.80083	.79810	.79541	.79273
105	.82726	.82451	.82178	.81907	.81638	.81371	.81106	.80843	.80582	.80322
106	.84137	.83879	.83623	.83368	.83115	.82863	.82614	.82366	.82119	.81874
107	.86211	.85981	.85751	.85523	.85297	.85071	.84847	.84624	.84403	.84182
108	.89660	.89481	.89304	.89127	.88950	.88775	.88601	.88427	.88254	.88081
109	.95372	.95290	.95208	.95126	.95045	.94964	.94883	.94803	.94723	.94643

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
0	.01683	.01669	.01655	.01642	.01630	.01618	.01607	.01596	.01586	.01576
1	.00559	.00544	.00531	.00518	.00506	.00494	.00484	.00473	.00464	.00454
2	.00528	.00513	.00499	.00485	.00473	.00461	.00449	.00439	.00428	.00419
3	.00524	.00508	.00493	.00479	.00465	.00453	.00441	.00429	.00419	.00408
4	.00536	.00519	.00503	.00488	.00473	.00460	.00447	.00435	.00423	.00412
5	.00558	.00540	.00523	.00507	.00492	.00477	.00464	.00451	.00439	.00427
6	.00588	.00569	.00550	.00533	.00517	.00502	.00487	.00473	.00460	.00448
7	.00624	.00604	.00584	.00566	.00549	.00532	.00517	.00502	.00488	.00475
8	.00668	.00646	.00626	.00606	.00588	.00570	.00554	.00538	.00523	.00509
9	.00722	.00699	.00677	.00656	.00636	.00617	.00600	.00583	.00567	.00552
10	.00785	.00761	.00737	.00715	.00694	.00674	.00655	.00637	.00620	.00604
11	.00861	.00835	.00810	.00786	.00764	.00743	.00723	.00704	.00686	.00668
12	.00946	.00918	.00891	.00866	.00843	.00820	.00799	.00779	.00760	.00741
13	.01035	.01006	.00978	.00951	.00927	.00903	.00880	.00859	.00839	.00819
14	.01122	.01091	.01061	.01034	.01007	.00982	.00958	.00936	.00914	.00894
15	.01203	.01171	.01140	.01110	.01082	.01056	.01031	.01007	.00985	.00963
16	.01279	.01244	.01211	.01181	.01151	.01123	.01097	.01072	.01048	.01025
17	.01347	.01311	.01276	.01244	.01213	.01184	.01156	.01130	.01104	.01081
18	.01411	.01373	.01336	.01302	.01270	.01239	.01210	.01182	.01155	.01130
19	.01474	.01434	.01396	.01359	.01325	.01293	.01262	.01233	.01205	.01178
20	.01537	.01494	.01454	.01415	.01379	.01345	.01313	.01282	.01252	.01224
21	.01598	.01553	.01510	.01470	.01432	.01396	.01361	.01329	.01298	.01268
22	.01660	.01613	.01568	.01525	.01485	.01446	.01410	.01375	.01343	.01312
23	.01725	.01674	.01627	.01581	.01539	.01498	.01460	.01423	.01388	.01355
24	.01796	.01742	.01692	.01644	.01599	.01556	.01515	.01476	.01439	.01404
25	.01876	.01819	.01765	.01714	.01666	.01621	.01577	.01536	.01497	.01460
26	.01967	.01907	.01850	.01796	.01745	.01696	.01650	.01606	.01565	.01525
27	.02072	.02008	.01948	.01890	.01836	.01784	.01735	.01688	.01644	.01601
28	.02190	.02122	.02057	.01996	.01938	.01883	.01831	.01781	.01734	.01689
29	.02322	.02249	.02181	.02116	.02054	.01996	.01940	.01887	.01836	.01788
30	.02469	.02392	.02319	.02250	.02184	.02122	.02062	.02006	.01952	.01900
31	.02634	.02552	.02475	.02401	.02331	.02264	.02201	.02140	.02083	.02028
32	.02816	.02729	.02647	.02568	.02494	.02423	.02355	.02291	.02229	.02170
33	.03018	.02926	.02838	.02755	.02675	.02600	.02528	.02459	.02393	.02331
34	.03239	.03142	.03048	.02960	.02875	.02795	.02718	.02645	.02575	.02508
35	.03482	.03378	.03279	.03185	.03095	.03009	.02928	.02850	.02775	.02704
36	.03743	.03633	.03528	.03428	.03333	.03242	.03155	.03072	.02992	.02916
37	.04026	.03909	.03798	.03692	.03591	.03494	.03401	.03313	.03228	.03147
38	.04330	.04207	.04089	.03977	.03869	.03767	.03668	.03574	.03484	.03398
39	.04658	.04528	.04403	.04284	.04170	.04061	.03957	.03857	.03762	.03670
40	.05011	.04873	.04741	.04615	.04495	.04379	.04269	.04163	.04061	.03964
41	.05389	.05244	.05104	.04971	.04844	.04721	.04604	.04492	.04384	.04281
42	.05791	.05638	.05491	.05350	.05216	.05086	.04962	.04844	.04729	.04620
43	.06219	.06057	.05902	.05754	.05612	.05475	.05344	.05218	.05098	.04981
44	.06673	.06503	.06340	.06184	.06034	.05890	.05752	.05619	.05491	.05368
45	.07157	.06978	.06806	.06642	.06484	.06332	.06186	.06046	.05911	.05781
46	.07669	.07481	.07301	.07128	.06962	.06802	.06649	.06501	.06358	.06221
47	.08212	.08015	.07826	.07645	.07470	.07302	.07140	.06984	.06834	.06690
48	.08784	.08578	.08380	.08190	.08006	.07830	.07660	.07496	.07338	.07186
49	.09384	.09169	.08961	.08762	.08570	.08384	.08206	.08034	.07868	.07708
50	.10013	.09787	.09570	.09361	.09160	.08966	.08779	.08598	.08424	.08256
51	.10671	.10436	.10209	.09991	.09780	.09577	.09381	.09192	.09009	.08832
52	.11365	.11120	.10883	.10655	.10435	.10222	.10017	.09819	.09628	.09442
53	.12095	.11840	.11593	.11355	.11126	.10904	.10689	.10482	.10282	.10088
54	.12860	.12595	.12338	.12090	.11851	.11619	.11396	.11179	.10970	.10767
55	.13663	.13386	.13120	.12862	.12613	.12372	.12138	.11912	.11694	.11482
56	.14503	.14217	.13940	.13672	.13413	.13162	.12919	.12683	.12456	.12235
57	.15385	.15089	.14801	.14523	.14254	.13994	.13741	.13496	.13259	.13029
58	.16311	.16004	.15706	.15418	.15139	.14868	.14606	.14352	.14105	.13866
59	.17279	.16961	.16654	.16355	.16066	.15786	.15514	.15250	.14994	.14745
60	.18286	.17958	.17640	.17332	.17033	.16743	.16462	.16188	.15922	.15664
61	.19330	.18992	.18665	.18347	.18038	.17738	.17447	.17164	.16889	.16622
62	.20409	.20061	.19724	.19396	.19078	.18768	.18467	.18175	.17891	.17614
63	.21522	.21165	.20818	.20480	.20152	.19833	.19523	.19221	.18928	.18642
64	.22672	.22306	.21949	.21602	.21265	.20937	.20617	.20306	.20003	.19708
65	.23867	.23491	.23125	.22769	.22423	.22085	.21757	.21437	.21125	.20821
66	.25112	.24727	.24353	.23988	.23632	.23286	.22948	.22619	.22299	.21986
67	.26409	.26016	.25633	.25260	.24896	.24541	.24195	.23857	.23528	.23206
68	.27760	.27359	.26968	.26586	.26214	.25851	.25497	.25151	.24814	.24484

TABLE S—BASED ON LIFE TABLE 80CNSMT SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989, and Before May 1, 1999]

Age	Interest rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
69	.29157	.28748	.28350	.27961	.27581	.27211	.26849	.26495	.26150	.25812
70	.30596	.30181	.29775	.29379	.28992	.28614	.28245	.27884	.27532	.27187
71	.32069	.31648	.31236	.30833	.30440	.30055	.29679	.29312	.28952	.28600
72	.33578	.33151	.32733	.32325	.31925	.31535	.31152	.30778	.30412	.30054
73	.35123	.34691	.34269	.33855	.33450	.33054	.32666	.32286	.31914	.31550
74	.36715	.36279	.35852	.35434	.35024	.34623	.34230	.33845	.33468	.33098
75	.38360	.37921	.37491	.37069	.36656	.36250	.35853	.35464	.35082	.34708
76	.40064	.39623	.39190	.38765	.38349	.37941	.37540	.37148	.36762	.36384
77	.41823	.41381	.40947	.40521	.40103	.39692	.39290	.38895	.38507	.38126
78	.43632	.43189	.42755	.42329	.41910	.41499	.41095	.40698	.40309	.39926
79	.45473	.45032	.44599	.44173	.43755	.43344	.42940	.42543	.42153	.41770
80	.47333	.46894	.46463	.46040	.45623	.45213	.44811	.44414	.44025	.43642
81	.49191	.48755	.48328	.47907	.47493	.47085	.46684	.46290	.45902	.45520
82	.51034	.50603	.50179	.49762	.49351	.48947	.48549	.48157	.47772	.47392
83	.52852	.52427	.52008	.51595	.51189	.50788	.50394	.50006	.49623	.49246
84	.54648	.54228	.53815	.53407	.53006	.52610	.52221	.51836	.51458	.51084
85	.56426	.56013	.55606	.55205	.54810	.54420	.54035	.53656	.53282	.52913
86	.58169	.57764	.57364	.56970	.56581	.56197	.55818	.55445	.55076	.54713
87	.59850	.59452	.59060	.58673	.58291	.57913	.57541	.57174	.56811	.56453
88	.61476	.61086	.60702	.60322	.59947	.59577	.59212	.58851	.58494	.58142
89	.63078	.62697	.62321	.61950	.61583	.61220	.60862	.60508	.60159	.59813
90	.64674	.64302	.63935	.63573	.63215	.62861	.62511	.62165	.61823	.61485
91	.66238	.65877	.65520	.65167	.64819	.64474	.64133	.63795	.63462	.63132
92	.67730	.67379	.67032	.66689	.66350	.66014	.65682	.65354	.65029	.64708
93	.69130	.68789	.68452	.68119	.67789	.67463	.67140	.66820	.66504	.66191
94	.70421	.70090	.69762	.69438	.69118	.68800	.68486	.68175	.67867	.67563
95	.71594	.71272	.70954	.70639	.70326	.70017	.69712	.69409	.69109	.68812
96	.72638	.72325	.72014	.71707	.71403	.71101	.70803	.70507	.70215	.69925
97	.73590	.73285	.72982	.72682	.72385	.72090	.71799	.71510	.71224	.70941
98	.74448	.74149	.73853	.73560	.73269	.72981	.72696	.72414	.72134	.71856
99	.75240	.74948	.74658	.74371	.74086	.73805	.73525	.73248	.72974	.72702
100	.75974	.75687	.75403	.75121	.74842	.74566	.74292	.74020	.73751	.73484
101	.76669	.76388	.76109	.75833	.75559	.75287	.75018	.74751	.74486	.74223
102	.77393	.77117	.76844	.76573	.76304	.76037	.75773	.75511	.75251	.74993
103	.78158	.77888	.77620	.77355	.77091	.76830	.76571	.76313	.76058	.75805
104	.79007	.78743	.78482	.78222	.77964	.77709	.77455	.77203	.76953	.76705
105	.80065	.79809	.79556	.79304	.79054	.78805	.78559	.78314	.78071	.77829
106	.81631	.81389	.81149	.80911	.80674	.80438	.80204	.79972	.79741	.79511
107	.83963	.83745	.83529	.83313	.83099	.82886	.82674	.82463	.82254	.82045
108	.87910	.87739	.87569	.87400	.87232	.87064	.86897	.86731	.86566	.86401
109	.94563	.94484	.94405	.94326	.94248	.94170	.94092	.94014	.93937	.93860

[Redesignated from 36 FR 6480, Apr. 6, 1971. T.D. 8540, 59 FR 30102, 30105, 30116, June 10, 1994, as amended by T.D. 8819, 64 FR 23190, 23199, 23228, Apr. 30, 1999; 64 FR 33196, June 22, 1999; T.D. 8886, 65 FR 36943, June 12, 2000]

ELECTION TO TREAT TRUST AS PART OF AN ESTATE

§ 1.645–1 Election by certain revocable trusts to be treated as part of estate.

(a) *In general.* If an election is filed for a qualified revocable trust, as defined in paragraph (b)(1) of this section, in accordance with the rules set forth in paragraph (c) of this section, the qualified revocable trust is treated and taxed for purposes of subtitle A of the Internal Revenue Code as part of its related estate, as defined in paragraph (b)(5) of this section (and not as a separate trust) during the election period, as defined in paragraph (b)(6) of this section. Rules regarding the use of taxpayer identification numbers (TINs) and the filing of a Form 1041, ''U.S. Income Tax Return for Estates and Trusts,'' for a qualified revocable trust are in paragraph (d) of this section. Rules regarding the tax treatment of an electing trust and related estate and the general filing requirements for the combined entity during the election period are in paragraph (e)(2) of this section. Rules regarding the tax treatment of an electing trust and its filing requirements during the election period if no executor, as defined in paragraph (b)(4) of this section, is appointed for a related estate are in paragraph (e)(3) of this section. Rules for determining the duration of the section 645 election period are in paragraph (f) of this section. Rules regarding the tax effects of the termination of the election are in paragraph (h) of this section. Rules regarding the tax consequences of the appointment of an executor after a trustee has made a section 645 election believing that an executor would not be appointed for a related estate are in paragraph (g) of this section.

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

(1) *Qualified revocable trust.* A *qualified revocable trust* (QRT) is any trust (or portion thereof) that on the date of death of the decedent was treated as owned by the decedent under section 676 by reason of a power held by the decedent (determined without regard to section 672(e)). A trust that was treated as owned by the decedent under section 676 by reason of a power that was exercisable by the decedent only with the approval or consent of a nonadverse party or with the approval or consent of the decedent's spouse is a QRT. A trust that was treated as owned by the decedent under section 676 solely by reason of a power held by a nonadverse party or by reason of a power held by the decedent's spouse is not a QRT.

(2) *Electing trust.* An *electing trust* is a QRT for which a valid section 645 election has been made. Once a section 645 election has been made for the trust, the trust shall be treated as an electing trust throughout the entire election period.

(3) *Decedent.* The *decedent* is the individual who was treated as the owner of the *QRT* under section 676 on the date of that individual's death.

(4) *Executor.* An *executor* is an executor, personal representative, or administrator that has obtained letters of appointment to administer the decedent's estate through formal or informal appointment procedures. Solely for purposes of this paragraph (b)(4), an executor does not include a person that has actual or constructive possession of property of the decedent unless that person is also appointed or qualified as an executor, administrator, or personal representative of the decedent's estate. If more than one jurisdiction has appointed an executor, the executor appointed in the domiciliary or primary proceeding is the executor of the related estate for purposes of this paragraph (b)(4).

(5) *Related estate.* A *related estate* is the estate of the decedent who was treated as the owner of the QRT on the date of the decedent's death.

(6) *Election period.* The *election period* is the period of time during which an electing trust is treated and taxed as part of its related estate. The rules for determining the duration of the election period are in paragraph (f) of this section.

(c) *The election*—(1) *Filing the election if there is an executor*—(i) *Time and manner for filing the election.* If there is an executor of the related estate, the trustees of each QRT joining in the election and the executor of the related estate make an election under section 645 and this section to treat each QRT joining in the election as part of the related estate for purposes of subtitle A of the Internal Revenue Code by filing a form provided by the IRS for making the election (election form) properly completed and signed under penalties of perjury, or in any other manner prescribed after December 24, 2002 by forms provided by the Internal Revenue Service (IRS), or by other published guidance for making the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of the related estate (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the related estate, the election form will be timely filed if it is filed by the time prescribed for filing the Form 1041 including the extension granted with respect to the Form 1041.

(ii) *Conditions to election.* In addition to providing the information required by the election form, as a condition to a valid section 645 election, the trustee of each QRT joining in the election and the executor of the related estate agree, by signing the election form under penalties of perjury, that:

(A) With respect to a trustee—

(*1*) The trustee agrees to the election;

(*2*) The trustee is responsible for timely providing the executor of the related estate with all the trust information necessary to permit the executor to file a complete, accurate, and timely Form 1041 for the combined electing trust(s) and related estate for each taxable year during the election period;

(*3*) The trustee of each QRT joining the election and the executor of the related estate have agreed to allocate the tax burden of the combined electing trust(s) and related estate for each taxable year during the election period in a manner that reasonably reflects the tax obligations of each electing trust and the related estate; and

(*4*) The trustee is responsible for insuring that the electing trust's share of the tax obligations of the combined electing trust(s) and related estate is timely paid to the Secretary.

(B) With respect to the executor—

(*1*) The executor agrees to the election;

(*2*) The executor is responsible for filing a complete, accurate, and timely Form 1041 for the combined electing trust(s) and related estate for each taxable year during the election period;

(*3*) The executor and the trustee of each QRT joining in the election have agreed to allocate the tax burden of the combined electing trust(s) and related estate for each taxable year during the election period in a manner that reasonably reflects the tax obligations of each electing trust and the related estate;

(*4*) The executor is responsible for insuring that the related estate's share of the tax obligations of the combined electing trust(s) and related estate is timely paid to the Secretary.

(2) *Filing the election if there is no executor*—(i) *Time and manner for filing the election.* If there is no executor for a related estate, an election to treat one or more QRTs of the decedent as an estate for purposes of subtitle A of the Internal Revenue Code is made by the trustees of each QRT joining in the election, by filing a properly completed election form, or in any other manner prescribed after December 24, 2002 by forms provided by the IRS, or by other published guidance for making the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of the trust, taking into account the trustee's election to treat the trust as an estate under section 645 (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the electing trust, the election form will be timely filed if it is filed by the time prescribed for filing the Form 1041 including the extension granted with respect to the filing of the Form 1041.

(ii) *Conditions to election.* In addition to providing the information required by the election form, as a condition to a valid section 645 election, the trustee of each QRT joining in the election agrees, by signing the election form under penalties of perjury, that—

(A) The trustee agrees to the election;

(B) If there is more than one QRT joining in the election, the trustees of each QRT joining in the election have appointed one trustee to be responsible for filing the Form 1041 for the combined electing trusts for each taxable year during the election period (filing trustee) and the filing trustee has agreed to accept that responsibility;

(C) If there is more than one QRT, the trustees of each QRT joining in the election have agreed to allocate the tax liability of the combined electing trusts for each taxable year during the election period in a manner that reasonably reflects the tax obligations of each electing trust;

(D) The trustee agrees to:

(*1*) Timely file a Form 1041 for the electing trust(s) for each taxable year during the election period; or

(*2*) If there is more than one QRT and the trustee is not the filing trustee, timely provide the filing trustee with all of the electing trust's information necessary to permit the filing trustee to file a complete, accurate, and timely

Form 1041 for the combined electing trusts for each taxable year during the election period;

(*3*) Insure that the electing trust's share of the tax burden is timely paid to the Secretary;

(E) There is no executor and, to the knowledge and belief of the trustee, one will not be appointed; and

(F) If an executor is appointed after the filing of the election form and the executor agrees to the section 645 election, the trustee will complete and file a revised election form with the executor.

(3) *Election for more than one QRT.* If there is more than one QRT, the election may be made for some or all of the QRTs. If there is no executor, one trustee must be appointed by the trustees of the electing trusts to file Forms 1041 for the combined electing trusts filing as an estate during the election period.

(d) *TIN and filing requirements for a QRT*—(1) *Obtaining a TIN.* Regardless of whether there is an executor for a related estate and regardless of whether a section 645 election will be made for the QRT, a TIN must be obtained for the QRT following the death of the decedent. See §301.6109–1(a)(3) of this chapter. The trustee must furnish this TIN to the payors of the QRT. See §301.6109–1(a)(5) of this chapter for the definition of payor.

(2) *Filing a Form 1041 for a QRT*—(i) *Option not to file a Form 1041 for a QRT for which a section 645 election will be made.* If a section 645 election will be made for a QRT, the executor of the related estate, if any, and the trustee of the QRT may treat the QRT as an electing trust from the decedent's date of death until the due date for the section 645 election. Accordingly, the trustee of the QRT is not required to file a Form 1041 for the QRT for the short taxable year beginning with the decedent's date of death and ending December 31 of that year. However, if a QRT is treated as an electing trust under this paragraph from the decedent's date of death until the due date for the section 645 election but a valid section 645 election is not made for the QRT, the QRT will be subject to penalties and interest for failing to timely file a Form 1041 and pay the tax due thereon.

(ii) *Requirement to file a Form 1041 for a QRT if paragraph (d)(2)(i) of this section does not apply*—(A) *Requirement to file Form 1041.* If the trustee of the QRT and the executor of the related estate, if any, do not treat the QRT as an electing trust as provided under paragraph (d)(2)(i) of this section, or if the trustee of the electing trust and the executor, if any, are uncertain whether a section 645 election will be made for a QRT, the trustee of the QRT must file a Form 1041 for the short taxable year beginning with the decedent's death and ending December 31 of that year (unless the QRT is not required to file a Form 1041 under section 6012 for this period).

(B) *Requirement to amend Form 1041 if a section 645 election is made*—(*1*) *If there is an executor.* If there is an executor and a valid section 645 election is made for a QRT after a Form 1041 has been filed for the QRT as a trust (see paragraph (d)(2)(ii)(A) of this section), the trustee must amend the Form 1041. The QRT's items of income, deduction, and credit must be excluded from the amended Form 1041 filed under this paragraph and must be included on the Form 1041 filed for the first taxable year of the combined electing trust and related estate under paragraph (e)(2)(ii)(A) of this section.

(*2*) *If there is no executor.* If there is no executor and a valid section 645 election is made for a QRT after a Form 1041 has been filed for the QRT as a trust (see paragraph (d)(2)(ii)(A) of this section) for the short taxable year beginning with the decedent's death and ending December 31 of that year, the trustee must file an amended return for the QRT. The amended return must be filed consistent with paragraph (e)(3) of this section and must be filed by the due date of the Form 1041 for the QRT, taking into account the trustee's election under section 645.

(e) *Tax treatment and general filing requirements of electing trust and related estate during the election period*—(1) *Effect of election.* The section 645 election once made is irrevocable.

(2) *If there is an executor*—(i) *Tax treatment of the combined electing trust and related estate.* If there is an executor,

the electing trust is treated, during the election period, as part of the related estate for all purposes of subtitle A of the Internal Revenue Code. Thus, for example, the electing trust is treated as part of the related estate for purposes of the set-aside deduction under section 642(c)(2), the subchapter S shareholder requirements of section 1361(b)(1), and the special offset for rental real estate activities in section 469(i)(4).

(ii) *Filing requirements*—(A) *Filing the Form 1041 for the combined electing trust and related estate during the election period.* If there is an executor, the executor files a single income tax return annually (assuming a return is required under section 6012) under the name and TIN of the related estate for the combined electing trust and the related estate. Information regarding the name and TIN of each electing trust must be provided on the Form 1041 as required by the instructions to that form. The period of limitations provided in section 6501 for assessments with respect to an electing trust and the related estate starts with the filing of the return required under this paragraph. Except as required under the separate share rules of section 663(c), for purposes of filing the Form 1041 under this paragraph and computing the tax, the items of income, deduction, and credit of the electing trust and related estate are combined. One personal exemption in the amount of $600 is permitted under section 642(b), and the tax is computed under section 1(e), taking into account section 1(h), for the combined taxable income.

(B) *Filing a Form 1041 for the electing trust is not required.* Except for any final Form 1041 required to be filed under paragraph (h)(2)(i)(B) of this section, if there is an executor, the trustee of the electing trust does not file a Form 1041 for the electing trust during the election period. Although the trustee is not required to file a Form 1041 for the electing trust, the trustee of the electing trust must timely provide the executor of the related estate with all the trust information necessary to permit the executor to file a complete, accurate and timely Form 1041 for the combined electing trust and related estate. The trustee must also insure that the electing trust's share of the tax obligations of the combined electing trust and related estate is timely paid to the Secretary. In certain situations, the trustee of a QRT may be required to file a Form 1041 for the QRT's short taxable year beginning with the date of the decedent's death and ending December 31 of that year. See paragraph (d)(2) of this section.

(iii) *Application of the separate share rules*—(A) *Distributions to beneficiaries (other than to a share (or shares) of the combined electing trust and related estate).* Under the separate share rules of section 663(c), the electing trust and related estate are treated as separate shares for purposes of computing distributable net income (DNI) and applying the distribution provisions of sections 661 and 662. Further, the electing trust share or the related estate share may each contain two or more shares. Thus, if during the taxable year, a distribution is made by the electing trust or the related estate, the DNI of the share making the distribution must be determined and the distribution provisions of sections 661 and 662 must be applied using the separately determined DNI applicable to the distributing share.

(B) *Adjustments to the DNI of the separate shares for distributions between shares to which sections 661 and 662 would apply.* A distribution from one share to another share to which sections 661 and 662 would apply if made to a beneficiary other than another share of the combined electing trust and related estate affects the computation of the DNI of the share making the distribution and the share receiving the distribution. The share making the distribution reduces its DNI by the amount of the distribution deduction that it would be entitled to under section 661 (determined without regard to section 661(c)), had the distribution been made to another beneficiary, and, solely for purposes of calculating DNI, the share receiving the distribution increases its gross income by the same amount. The distribution has the same character in the hands of the recipient share as in the hands of the distributing share. The following example illustrates the provisions of this paragraph (e)(2)(iii)(B):

Example. (i) A's will provides that, after the payment of debts, expenses, and taxes, the residue of A's estate is to be distributed to Trust, an electing trust. The sole beneficiary of Trust is C. The estate share has $15,000 of gross income, $5,000 of deductions, and $10,000 of taxable income and DNI for the taxable year based on the assets held in A's estate. During the taxable year, A's estate distributes $15,000 to Trust. The distribution reduces the DNI of the estate share by $10,000.

(ii) For the same taxable year, the trust share has $25,000 of gross income and $5,000 of deductions. None of the modifications provided for under section 643(a) apply. In calculating the DNI for the trust share, the gross income of the trust share is increased by $10,000, the amount of the reduction in the DNI of the estate share as a result of the distribution to Trust. Thus, solely for purposes of calculating DNI, the trust share has gross income of $35,000, and taxable income of $30,000. Therefore, the trust share has $30,000 of DNI for the taxable year.

(iii) During the same taxable year, Trust distributes $35,000 to C. The distribution deduction reported on the Form 1041 filed for A's estate and Trust is $30,000. As a result of the distribution by Trust to C, C must include $30,000 in gross income for the taxable year. The gross income reported on the Form 1041 filed for A's estate and Trust is $40,000.

(iv) *Application of the governing instrument requirement of section 642(c).* A deduction is allowed in computing the taxable income of the combined electing trust and related estate to the extent permitted under section 642(c) for—

(A) Any amount of the gross income of the related estate that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the related estate for a purpose specified in section 170(c); and

(B) Any amount of gross income of the electing trust that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the electing trust for a purpose specified in section 170(c).

(3) *If there is no executor*—(i) *Tax treatment of the electing trust.* If there is no executor, the trustee treats the electing trust, during the election period, as an estate for all purposes of subtitle A of the Internal Revenue Code. Thus, for example, an electing trust is treated as an estate for purposes of the set-aside deduction under section 642(c)(2), the subchapter S shareholder requirements of section 1361(b)(1), and the special offset for rental real estate activities under section 469(i)(4). The trustee may also adopt a taxable year other than a calendar year.

(ii) *Filing the Form 1041 for the electing trust.* If there is no executor, the trustee of the electing trust must, during the election period, file a Form 1041, under the TIN obtained by the trustee under § 301.6109–1(a)(3) of this chapter upon the death of the decedent, treating the trust as an estate. If there is more than one electing trust, the Form 1041 must be filed by the filing trustee (see paragraph (c)(2)(ii)(B) of this section) under the name and TIN of the electing trust of the filing trustee. Information regarding the names and TINs of the other electing trusts must be provided on the Form 1041 as required by the instructions to that form. Any return filed in accordance with this paragraph shall be treated as a return filed for the electing trust (or trusts, if there is more than one electing trust) and not as a return filed for any subsequently discovered related estate. Accordingly, the period of limitations provided in section 6501 for assessments with respect to a subsequently discovered related estate does not start until a return is filed with respect to the related estate. See paragraph (g) of this section.

(4) *Application of the section 6654(l)(2) to the electing trust.* Each electing trust and related estate (if any) is treated as a separate taxpayer for all purposes of subtitle F of the Internal Revenue Code, including, without limitation, the application of section 6654. The provisions of section 6654(l)(2)(A) relating to the two year exception to an estate's obligation to make estimated tax payments, however, will apply to each electing trust for which a section 645 election has been made.

(f) *Duration of election period*—(1) *In general.* The election period begins on the date of the decedent's death and terminates on the earlier of the day on which both the electing trust and related estate, if any, have distributed all of their assets, or the day before the applicable date. The election does not apply to successor trusts (trusts that are distributees under the trust instrument).

(2) *Definition of applicable date*—(i) *Applicable date if no Form 706 ''United States Estate (and Generation Skipping Transfer) Tax Return'' is required to be filed.* If a Form 706 is not required to be filed as a result of the decedent's death, the applicable date is the day which is 2 years after the date of the decedent's death.

(ii) *Applicable date if a Form 706 is required to be filed.* If a Form 706 is required to be filed as a result of the decedent's death, the applicable date is the later of the day that is 2 years after the date of the decedent's death, or the day that is 6 months after the date of final determination of liability for estate tax. Solely for purposes of determining the applicable date under section 645, the date of final determination of liability is the earliest of the following—

(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

(B) The date of a final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

(C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

(iii) *Definition of final disposition of claim for refund.* For purposes of paragraph (f)(2)(ii)(B) of this section, a claim for refund shall be deemed finally disposed of by the Secretary when all items have been either allowed or disallowed. If a waiver of notification with respect to disallowance is filed with respect to a claim for refund prior to disallowance of the claim, the claim for refund will be treated as disallowed on the date the waiver is filed.

(iv) *Examples.* The application of this paragraph (f)(2) is illustrated by the following examples:

Example 1. A died on October 20, 2002. The executor of *A*'s estate and the trustee of Trust, an electing trust, made a section 645 election. A Form 706 is not required to be filed as a result of *A*'s death. The applicable date is October 20, 2004, the day that is two years after *A*'s date of death. The last day of the election period is October 19, 2004. Beginning October 20, 2004, Trust will no longer be treated and taxed as part of *A*'s estate.

Example 2. Assume the same facts as *Example 1,* except that a Form 706 is required to be filed as the result of *A*'s death. The Internal Revenue Service issues an estate tax closing letter accepting the Form 706 as filed on March 15, 2005. The estate does not file a claim for refund by March 15, 2006, the day that is twelve months after the date of issuance of the estate tax closing letter. The date of final determination of liability is September 15, 2005, and the applicable date is March 15, 2006. The last day of the election period is March 14, 2006. Beginning March 15, 2006, Trust will no longer be treated and taxed as part of *A*'s estate.

Example 3. Assume the same facts as *Example 1,* except that a Form 706 is required to be filed as the result of *A*'s death. The Form 706 is audited, and a notice of deficiency authorized under section 6212 is mailed to the executor of *A*'s estate as a result of the audit. The executor files a petition in Tax Court. The Tax Court issues a decision resolving the liability for estate tax on December 14, 2005, and neither party appeals within 90 days after the issuance of the decision. The date of final determination of liability is December 14, 2005. The applicable date is June 14, 2006, the day that is six months after the date of final determination of liability. The last day of the election period is June 13, 2006. Beginning June 14, 2006, Trust will no longer be treated and taxed as part of *A*'s estate.

(g) *Executor appointed after the section 645 election is made*—(1) *Effect on the election.* If an executor for the related estate is not appointed until after the trustee has made a valid section 645 election, the executor must agree to the trustee's election, and the IRS must be notified of that agreement by the filing of a revised election form (completed as required by the instructions to that form) within 90 days of the appointment of the executor, for the election period to continue past the date of appointment of the executor. If the executor does not agree to the election or a revised election form is not timely filed as required by this paragraph, the election period terminates the day before the appointment of the executor. If the IRS issues other guidance after December 24, 2002 for notifying the IRS of the executor's agreement to the election, the IRS must be notified in the manner provided in that guidance for the election period to continue.

(2) *Continuation of election period*—(i) *Correction of returns filed before executor appointed.* If the election period continues under paragraph (g)(1) of this section, the executor of the related estate and the trustee of each electing trust must file amended Forms 1041 to correct the Forms 1041 filed by the trustee before the executor was appointed. The amended Forms 1041 must be filed under the name and TIN of the electing trust and must reflect the items of income, deduction, and credit of the related estate and the electing trust. The name and TIN of the related estate must be provided on the amended Forms 1041 as required in the instructions to that Form. The amended return for the taxable year ending immediately before the executor was appointed must indicate that this Form 1041 is a final return. If the period of limitations for making assessments has expired with respect to the electing trust for any of the Forms 1041 filed by the trustee, the executor must file Forms 1041 for any items of income, deduction, and credit of the related estate that cannot be properly included on amended forms for the electing trust. The personal exemption under section 642(b) is not permitted to be taken on these Forms 1041 filed by the executor.

(ii) *Returns filed after the appointment of the executor.* All returns filed by the combined electing trust and related estate after the appointment of the executor are to be filed under the name and TIN of the related estate in accordance with paragraph (e)(2) of this section. Regardless of the change in the name and TIN under which the Forms 1041 for the combined electing trust and related estate are filed, the combined electing trust and related estate will be treated as the same entity before and after the executor is appointed.

(3) *Termination of the election period.* If the election period terminates under paragraph (g)(1) of this section, the executor must file Forms 1041 under the name and TIN of the estate for all taxable years of the related estate ending after the death of the decedent. The trustee of the electing trust is not required to amend any returns filed for the electing trust during the election period. Following termination of the election period, the trustee of the electing trust must obtain a new TIN. See § 301.6109–1(a)(4) of this chapter.

(h) *Treatment of an electing trust and related estate following termination of the election*—(1) *The share (or shares) comprising the electing trust is deemed to be distributed upon termination of the election period.* On the close of the last day of the election period, the combined electing trust and related estate, if there is an executor, or the electing trust, if there is no executor, is deemed to distribute the share (or shares, as determined under section 663(c)) comprising the electing trust to a new trust in a distribution to which sections 661 and 662 apply. All items of income, including net capital gains, that are attributable to the share (or shares) comprising the electing trust are included in the calculation of the distributable net income of the electing trust and treated as distributed by the combined electing trust and related estate, if there is an executor, or by the electing trust, if there is no executor, to the new trust. The combined electing trust and related estate, if there is an executor, or the electing trust, if there is no executor, is entitled to a distribution deduction to the extent permitted under section 661 in the taxable year in which the election period terminates as a result of the deemed distribution. The new trust shall include the amount of the deemed distribution in gross income to the extent required under section 662.

(2) *Filing of the Form 1041 upon the termination of the section 645 election*—(i) *If there is an executor*—(A) *Filing the Form 1041 for the year of termination.* If there is an executor, the Form 1041 filed under the name and TIN of the related

estate for the taxable year in which the election terminates includes—

(*1*) The items of income, deduction, and credit of the electing trust attributable to the period beginning with the first day of the taxable year of the combined electing trust and related estate and ending with the last day of the election period;

(*2*) The items of income, deduction, and credit, if any, of the related estate for the entire taxable year; and

(*3*) A deduction for the deemed distribution of the share (or shares) comprising the electing trust to the new trust as provided for under paragraph (h)(1) of this section.

(B) *Requirement to file a final Form 1041 under the name and TIN of the electing trust.* If the electing trust terminates during the election period, the trustee of the electing trust must file a Form 1041 under the name and TIN of the electing trust and indicate that the return is a final return to notify the IRS that the electing trust is no longer in existence. The items of income, deduction, and credit of the trust are not reported on this final Form 1041 but on the appropriate Form 1041 filed for the combined electing trust and related estate.

(ii) *If there is no executor.* If there is no executor, the taxable year of the electing trust closes on the last day of the election period. A Form 1041 is filed in the manner prescribed under paragraph (e)(3)(ii) of this section reporting the items of income, deduction, and credit of the electing trust for the short period ending with the last day of the election period. The Form 1041 filed under this paragraph includes a distribution deduction for the deemed distribution provided for under paragraph (h)(1) of this section. The Form 1041 must indicate that it is a final return.

(3) *Use of TINs following termination of the election*—(i) *If there is an executor.* Upon termination of the section 645 election, a former electing trust may need to obtain a new TIN. See § 301.6109–1(a)(4) of this chapter. If the related estate continues after the termination of the election period, the related estate must continue to use the TIN assigned to the estate during the election period.

(ii) *If there is no executor.* If there is no executor, the former electing trust must obtain a new TIN if the trust will continue after the termination of the election period. See § 301.6109–1(a)(4) of this chapter.

(4) *Taxable year of estate and trust upon termination of the election*—(i) *Estate*—Upon termination of the section 645 election period, the taxable year of the estate is the same taxable year used during the election period.

(ii) *Trust.* Upon termination of the section 645 election, the taxable year of the new trust is the calendar year. See section 644.

(i) *Reserved.*

(j) *Effective date.* Paragraphs (a), (b), (c), (d), (f), and (g) of this section apply to trusts and estates of decedents dying on or after December 24, 2002. Paragraphs (e) and (h) of this section apply to taxable years ending on or after December 24, 2002.

[T.D. 9032, 67 FR 78377, Dec. 24, 2002]

TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY

§ 1.651(a)–1 Simple trusts; deduction for distributions; in general.

Section 651 is applicable only to a trust the governing instruments of which:

(a) Requires that the trust distribute all of its income currently for the taxable year, and

(b) Does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c),

and does not make any distribution other than of current income. A trust to which section 651 applies is referred to in this part as a ''simple'' trust. Trusts subject to section 661 are referred to as ''complex'' trusts. A trust may be a simple trust for one year and a complex trust for another year. It should be noted that under section 651 a trust qualifies as a simple trust in a taxable year in which it is required to distribute all its income currently and makes no other distributions, whether or not distributions of current income are in fact made. On the other hand a trust is not a complex trust by reason of distributions of amounts other than income unless such distributions are in fact made during the taxable year, whether or not they are required in that year.

§ 1.651(a)–2 Income required to be distributed currently.

(a) The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law. For this purpose, if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a ''simple'' trust. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter's income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust from treatment in 1955 under section 651, since the income is required to be distributed currently. However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust. For definition of the term ''income'' see section 643(b) and § 1.643(b)–1.

(b) It is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument. For example, if the fiduciary is required to distribute all the income currently, but has discretion to ''sprinkle'' the income among a class of beneficiaries, or among named beneficiaries, in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.

(c) If in one taxable year of a trust its income for that year is required or permitted to be accumulated, and in another taxable year its income for the year is required to be distributed currently (and no other amounts are distributed), the trust is a simple trust for the latter year. For example, a trust under which income may be accumulated until a beneficiary is 21 years old, and thereafter must be distributed currently, is a simple trust for taxable years beginning after the beneficiary reaches the age of 21 years in which no other amounts are distributed.

(d) If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 9102, 69 FR 20, Jan. 2, 2004]

§ 1.651(a)–3 Distribution of amounts other than income.

(a) A trust does not qualify for treatment under section 651 for any taxable year in which it actually distributes corpus. For example, a trust which is required to distribute all of its income currently would not qualify as a simple trust under section 651 in the year of its termination since in that year actual distributions of corpus would be made.

(b) A trust, otherwise qualifying under section 651, which may make a distribution of corpus in the discretion of the trustee, or which is required under the terms of its governing instrument to make a distribution of corpus upon the happening of a specified event, will be disqualified for treatment under section 651 only for the taxable year in which an actual distribution of corpus is made. For example: Under the terms of a trust, which is required to distribute all of its income currently, half of the corpus is to be distributed to beneficiary A when he becomes 30 years of age. The trust reports on the calendar year basis. On December 28, 1954, A becomes 30 years of age and the trustee distributes half of the corpus of the trust to him on January 3, 1955. The trust will be disqualified for treatment under section 651 only for the taxable year 1955, the year in which an actual distribution of corpus is made.

(c) See section 661 and the regulations thereunder for the treatment of trusts which distribute corpus or claim the charitable contributions deduction provided by section 642(c).

§ 1.651(a)–4 Charitable purposes.

A trust is not considered to be a trust which may pay, permanently set aside, or use any amount for charitable, etc., purposes for any taxable year for which it is not allowed a charitable, etc., deduction under section 642(c). Therefore, a trust with a remainder to a charitable organization is not disqualified for treatment as a simple trust if either (a) the remainder is subject to a contingency, so that no deduction would be allowed for capital gains or other amounts added to corpus as amounts permanently set aside for a charitable, etc., purpose under section 642 (c), or (b) the trust receives no capital gains or other income added to corpus for the taxable year for which such a deduction would be allowed.

§ 1.651(a)–5 Estates.

Subpart B has no application to an estate.

§ 1.651(b)–1 Deduction for distributions to beneficiaries.

In computing its taxable income, a simple trust is allowed a deduction for the amount of income which is required under the terms of the trust instrument to be distributed currently to beneficiaries. If the amount of income required to be distributed currently exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income. For this purpose the amount of income required to be distributed currently, or distributable net income, whichever is applicable, does not include items of trust income (adjusted for deductions allocable thereto) which are not included in the gross income of the trust. For determination of the character of the income required to be distributed currently, see § 1.652(b)–2. Accordingly, for the purposes of determining the deduction allowable to the trust under section 651, distributable net income is computed without the modifications specified in paragraphs (5), (6), and (7) of section 643(a), relating to tax-exempt interest, foreign income, and excluded dividends. For example: Assume that the distributable net income of a trust as computed under section 643(a) amounts to $99,000 but includes nontaxable income of $9,000. Then distributable net income for the purpose of determining the deduction allowable under section 651 is $90,000 ($99,000 less $9,000 nontaxable income).

§ 1.652(a)–1 Simple trusts; inclusion of amounts in income of beneficiaries.

Subject to the rules in §§ 1.652(a)–2 and 1.652(b)–1, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not distributed. Thus, the income of a simple trust is includible in the beneficiary's gross income for the taxable year in which the income is required to be distributed currently even though, as a matter of practical necessity, the income is not distributed until after the close of the taxable year of the trust. See § 1.642(a)(3)–2 with respect to time of receipt of dividends. See § 1.652(c)–1 for treatment of amounts required to be distributed where a beneficiary and the trust have different taxable years. The term *income required to be distributed currently* includes income required to be distributed currently which is in fact used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.

§ 1.652(a)–2 Distributions in excess of distributable net income.

If the amount of income required to be distributed currently to beneficiaries exceeds the distributable net income of the trust (as defined in section 643(a)), each beneficiary includes in his gross income an amount equivalent to his proportionate share of such distributable net income. Thus, if beneficiary A is to receive two-thirds of the trust income and B is to receive one-third, and the income required to be distributed currently is $99,000, A will receive $66,000 and B, $33,000. However, if the distributable net income, as determined under section 643(a) is only $90,000, A will include two-thirds ($60,000) of that sum in his gross income, and B will include one-third ($30,000) in his gross income. See §§ 1.652(b)–1 and 1.652(b)–2, however, for amounts which are not includible in the gross income of a beneficiary because of their tax-exempt character.

§ 1.652(b)–1 Character of amounts.

In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)–1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)–1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116. Also, to the extent that the amounts specified in § 1.652(a)–1 consist of ''earned income'' in the hands of the trust under the provisions of section 1348 such amount shall be treated under section 1348 as ''earned income'' in the hands of the beneficiary. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)–1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.652(b)–2 Allocation of income items.

(a) The amounts specified in § 1.652(a)–1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000, and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

(b) The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation. For example:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

§ 1.652(b)–3 Allocation of deductions.

Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

(a) All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See § 1.642(e)–1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.

(b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

(c) Examples of expenses which are considered as not directly attributable to a specific class of income are trustee's commissions, the rental of safe deposit boxes, and State income and personal property taxes.

(d) To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income in the manner provided in paragraph (b) of this section, except that any excess deductions attributable to tax-exempt income (other than dividends excluded under section 116) may not be offset against any other class of income. See section 265 and the regulations thereunder. Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect. However, if the excess deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.

§ 1.652(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income in accordance with section 652 (a) and (b) is based on the income of the trust for any taxable year or years ending with or within his taxable year. This rule applies to taxable years of normal duration as well as to so-called short taxable years. Income of the trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.652(c)–2 Death of individual beneficiaries.

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 652 for the taxable year of the trust in which his last taxable year ends. Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)–3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)–2.

§ 1.652(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 652(a) in its gross income for its last taxable year is computed with reference to §§ 1.652(c)–1 and 1.652(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.652(c)–4 Illustration of the provisions of sections 651 and 652.

The rules applicable to a trust required to distribute all of its income currently to its beneficiaries may be illustrated by the following example:

Example. (a) Under the terms of a simple trust all of the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. The trust and both beneficiaries file returns on the calendar year basis. No provision is made in the governing instrument with respect to depreciation. During the taxable year 1955, the trust had the following items of income and expense:

Rents	$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents	5,000
Trustee's commissions allocable to income account	2,600
Trustee's commissions allocable to principal account	1,300
Depreciation	5,000

(b) The income of the trust for fiduciary accounting purposes is $92,400, computed as follows:

Rents		$25,000
Dividends		50,000
Tax-exempt interest		25,000
Total		100,000
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions allocable to income account	2,600	
		7,600
Income computed under section 643(b)		92,400

One-half ($46,200) of the income of $92,400 is currently distributable to each beneficiary.

(c) The distributable net income of the trust computed under section 643(a) is $91,100, determined as follows (cents are disregarded in the computation):

Rents		$25,000
Dividends		50,000
Tax-exempt interest	$25,000	
Less: Expenses allocable thereto (25,000/100,000 ×$3,900)	975	
		24,025
Total		99,025
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions ($3,900 less $975 allocable to tax-exempt interest)	2,925	
		7,925
Distributable net income		91,100

In computing the distributable net income of $91,100, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to the beneficiaries and for personal exemption of the trust (section 643(a) (1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50-percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 were included (section 643(a) (5) and (7)). Since all of the income of the trust is required to be currently distributed, no deduction is allowable for depreciation in the absence of specific provisions in the governing instrument providing for the keeping of the trust corpus intact. See section 167(h) and the regulations thereunder.

(d) The deduction allowable to the trust under section 651(a) for distributions to the beneficiaries is $67,025, computed as follows:

Distributable net income computed under section 643(a) (see paragraph (c))		$91,100
Less:		
Tax-exempt interest as adjusted	$24,025	
Dividend exclusion	50	
		24,075
Distributable net income as determined under section 651(b)		67,025

Since the amount of the income ($92,400) required to be distributed currently by the trust exceeds the distributable net income ($67,025) as computed under section 651(b), the deduction allowable under section 651(a) is limited to the distributable net income of $67,025.

(e) The taxable income of the trust is $7,200 computed as follows:

Rents		$25,000
Dividends ($50,000 less $50 exclusion)		49,950
Long-term capital gains		15,000
Gross income		89,950
Deductions:		
Rental expenses	$5,000	
Trustee's commissions	2,925	
Capital gain deduction	7,500	
Distributions to beneficiaries	67,025	
Personal exemption	300	
		82,750
Taxable income		7,200

The trust is not allowed a deduction for the portion ($975) of the trustee's commissions allocable to tax-exempt interest in computing its taxable income.

(f) In determining the character of the amounts includible in the gross income of A and B, it is assumed that the trustee elects to allocate to rents the expenses not directly attributable to a specific item of income other than the portion ($975) of such expenses allocated to tax-exempt interest. The allocation of expenses among the items of income is shown below:

	Rents	Dividends	Tax-exempt interest	Total
Income for trust accounting purposes	$25,000	$50,000	$25,000	$100,000
Less:				
Rental expenses	5,000			5,000
Trustee's commissions	2,925		975	3,900
Total deductions	7,925	0	975	8,900
Character of amounts in the hands of the beneficiaries	17,075	50,000	24,025	[1] 91,100

[1] Distributable net income.

Inasmuch as the income of the trust is to be distributed equally to A and B, each is deemed to have received one-half of each item of income; that is, rents of $8,537.50, dividends of $25,000, and tax-exempt interest of $12,012.50. The dividends of $25,000 allocated to each beneficiary are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion provided by section 116 and the dividend received credit allowed under section 34. Also, each beneficiary is allowed a deduction of $2,500 for depreciation of rental property attributable to the portion (one-half) of the income of the trust distributed to him.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, Mar. 24, 1964]

ESTATES AND TRUSTS WHICH MAY ACCUMULATE INCOME OR WHICH DISTRIBUTE CORPUS

§ 1.661(a)–1 Estates and trusts accumulating income or distributing corpus; general.

Subpart C, part I, subchapter J, chapter 1 of the Code, is applicable to all decedents' estates and their beneficiaries, and to trusts and their beneficiaries other than trusts subject to the provisions of subpart B of such part I (relating to trusts which distribute current income only, or ''simple'' trusts). A trust which is required to distribute amounts other than income during the taxable year may be subject to subpart B, and not subpart C, in the absence of an actual distribution of amounts other than income during the taxable year. See §§ 1.651(a)–1 and 1.651(a)–3. A trust to which subpart C is applicable is referred to as a ''complex'' trust in this part. Section 661 has no application to amounts excluded under section 663(a).

§ 1.661(a)–2 Deduction for distributions to beneficiaries.

(a) In computing the taxable income of an estate or trust there is allowed under section 661(a) as a deduction for distributions to beneficiaries the sum of:

(1) The amount of income for the taxable year which is required to be distributed currently, and

(2) Any other amounts properly paid or credited or required to be distributed for such taxable year.

However, the total amount deductible under section 661(a) cannot exceed the distributable net income as computed under section 643(a) and as modified by section 661(c). See § 1.661(c)–1.

(b) The term *income required to be distributed currently* includes any amount required to be distributed which may be paid out of income or corpus (such as an annuity), to the extent it is paid out of income for the taxable year. See § 1.651(a)–2 which sets forth additional rules which are applicable in determining whether income of an estate or trust is required to be distributed currently.

(c) The term *any other amounts properly paid, credited, or required to be distributed* includes all amounts properly paid, credited, or required to be distributed by an estate or trust during the taxable year other than income required to be distributed currently. Thus, the term includes the payment of an annuity to the extent it is not paid out of income for the taxable year, and a distribution of property in kind (see paragraph (f) of this section). However, see section 663(a) and regulations thereunder for distributions which are not included. Where the income of an estate or trust may be accumulated or distributed in the discretion of the fiduciary, or where the fiduciary has a power to distribute corpus to a beneficiary, any such discretionary distribution would qualify under section 661(a)(2). The term also includes an amount applied or distributed for the support of a dependent of a grantor or of a trustee or cotrustee under the circumstances described in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year.

(d) The terms *income required to be distributed currently* and *any other amounts properly paid or credited or required to be distributed* also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.

(e) The terms *income required to be distributed currently* and *any other amounts properly paid or credited or required to be distributed* include amounts paid, or required to be paid, during the taxable year pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate. The term *any other amounts properly paid or credited or required to be distributed* does not include the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees.

(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This paragraph applies for taxable years of trusts and estates ending after January 2, 2004.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26912, Sept. 27, 1973; T.D. 9102, 69 FR 20, Jan. 2, 2004]

§ 1.661(b)–1 Character of amounts distributed; in general.

In the absence of specific provisions in the governing instrument for the allocation of different classes of income, or unless local law requires such an allocation, the amount deductible for distributions to beneficiaries under section 661(a) is treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. For example, if a trust has distributable net income of $20,000, consisting of $10,000 each of taxable interest and royalties and distributes $10,000 to beneficiary A, the deduction of $10,000 allowable under section 661(a) is deemed to consist of $5,000 each of taxable interest and royalties, unless the trust instrument specifically provides for the distribution or accumulation of different classes of income or unless local law requires such an allocation. See also § 1.661(c)–1.

§ 1.661(b)–2 Character of amounts distributed when charitable contributions are made.

In the application of the rule stated in § 1.661(b)–1, the items of deduction which enter into the computation of distributable net income are allocated among the items of income which enter into the computation of distributable net income in accordance with the rules set forth in § 1.652(b)–3, except that, in the absence of specific provisions in the governing instrument, or unless local law requires a different apportionment, amounts paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) are first ratably apportioned among each class of items of income entering into the computation of the distributable net income of the estate or trust, in accordance with the rules set out in paragraph (b) of § 1.643(a)–5.

§ 1.661(c)–1 Limitation on deduction.

An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[T.D. 6777, 29 FR 17809, Dec. 16, 1964]

§ 1.661(c)–2 Illustration of the provisions of section 661.

The provisions of section 661 may be illustrated by the following example:

Example. (a) Under the terms of a trust, which reports on the calendar year basis, $10,000 a year is required to be paid out of income to a designated charity. The balance of the income may, in the trustee's discretion, be accumulated or distributed to beneficiary A. Expenses are allocable against income and the trust instrument requires a reserve for depreciation. During the taxable year 1955 the trustee contributes $10,000 to charity and in his discretion distributes $15,000 of income to A. The trust has the following items of income and expense for the taxable year 1955:

Dividends	$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Rental expenses	2,000
Depreciation of rental property	3,000
Trustee's commissions	5,000

(b) The income of the trust for fiduciary accounting purposes is $40,000, computed as follows:

Dividends		$10,000
Partially tax-exempt interest		10,000
Fully tax-exempt interest		10,000
Rents		20,000
Total		50,000
Less:		
Rental expenses	$2,000	
Depreciation	3,000	
Trustee's commissions	5,000	
		10,000
Income as computed under section 643(b)		40,000

(c) The distributable net income of the trust as computed under section 643(a) is $30,000, determined as follows:

Rents			$20,000
Dividends			10,000
Partially tax-exempt interest			10,000
Fully tax-exempt interest		$10,000	
Less:			
Expenses allocable thereto (10,000/50,000×$5,000)	$1,000		
Charitable contributions allocable thereto (10,000/50,000×$10,000)	2,000		
		3,000	
			7,000
Total			47,000
Deductions:			
Rental expenses		2,000	
Depreciation of rental property		3,000	
Trustee's commissions ($5,000 less $1,000 allocated to tax-exempt interest)		4,000	
Charitable contributions ($10,000 less $2,000 allocated to tax-exempt interest)		8,000	
			17,000
Distributable net income (section 643(a))			30,000

(d) The character of the amounts distributed under section 661(a), determined in accordance with the rules prescribed in §§ 1.661(b)–1 and 1.661(b)–2 is shown by the following table (for the purpose of this allocation, it is assumed that the trustee elected to allocate the trustee's commissions to rental income except for the amount required to be allocated to tax-exempt interest):

	Rental income	Taxable dividends	Excluded dividends	Partially tax-exempt interest	Tax-exempt interest	Total
Trust income	$20,000	$9,950	$50	$10,000	$10,000	$50,000
Less:						
Charitable contributions	4,000	2,000		2,000	2,000	10,000
Rental expenses	2,000					2,000
Depreciation	3,000					3,000
Trustee's commissions	4,000				1,000	5,000
Total deductions	13,000	2,000	0	2,000	3,000	20,000
Distributable net income	7,000	7,950	50	8,000	7,000	30,000

	Rental income	Taxable dividends	Excluded dividends	Partially tax-exempt interest	Tax-exempt interest	Total
Amounts deemed distributed under section 661(a) before applying the limitation of section 661(c)	3,500	3,975	25	4,000	3,500	15,000

In the absence of specific provisions in the trust instrument for the allocation of different classes of income, the charitable contribution is deemed to consist of a pro rata portion of the gross amount of each items of income of the trust (except dividends excluded under section 116) and the trust is deemed to have distributed to A a pro rata portion (one-half) of each item of income included in distributable net income.

(e) The taxable income of the trust is $11,375 computed as follows:

Rental income		$20,000
Dividends ($10,000 less $50 exclusion)		9,950
Partially tax-exempt interest		10,000
Gross income		39,950
Deductions:		
Rental expenses	$2,000	
Depreciation of rental property	3,000	
Trustee's commissions	4,000	
Charitable contributions	8,000	
Distributions to A	11,475	
Personal exemption	100	
		28,575
Taxable income		11,375

In computing the taxable income of the trust no deduction is allowable for the portions of the charitable contributions deduction ($2,000) and trustee's commissions ($1,000) which are treated under section 661(b) as attributable to the tax-exempt interest excludable from gross income. Also, of the dividends of $4,000 deemed to have been distributed to A under section 661(a), $25 (25/50ths of $50) is deemed to have been distributed from the excluded dividends and is not an allowable deduction to the trust. Accordingly, the deduction allowable under section 661 is deemed to be composed of $3,500 rental income, $3,975 of dividends, and $4,000 partially tax-exempt interest. No deduction is allowable for the portion of tax-exempt interest or for the portion of the excluded dividends deemed to have been distributed to the beneficiary.

(f) The trust is entitled to the credit allowed by section 34 with respect to dividends of $5,975 ($9,950 less $3,975 distributed to A) included in gross income. Also, the trust is allowed the credit provided by section 35 with respect to partially tax-exempt interest of $6,000 ($10,000 less $4,000 deemed distributed to A) included in gross income.

(g) Dividends of $4,000 allocable to A are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion under section 116 and the dividend received credit under section 84.

§ 1.662(a)–1 Inclusion of amounts in gross income of beneficiaries of estates and complex trusts; general.

There is included in the gross income of a beneficiary of an estate or complex trust the sum of:

(a) Amounts of income required to be distributed currently to him, and

(b) All other amounts properly paid, credited, or required to be distributed to him

by the estate or trust. The preceding sentence is subject to the rules contained in § 1.662(a)–2 (relating to currently distributable income), § 1.662(a)–3 (relating to other amounts distributed), and §§ 1.662(b)–1 and 1.662(b)–2 (relating to character of amounts). Section 662 has no application to amounts excluded under section 663(a).

§ 1.662(a)–2 Currently distributable income.

(a) There is first included in the gross income of each beneficiary under section 662(a)(1) the amount of income for the taxable year of the estate or trust required to be distributed currently to him, subject to the provisions of paragraph (b) of this section. Such amount is included in the beneficiary's gross income whether or not it is actually distributed.

(b) If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (as defined in section 643(a) but computed without taking into account the payment, crediting, or setting aside of an amount for which a charitable contributions deduction is allowable under section 642(c)) of the estate or trust, then there is included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to the beneficiary bears to the amount required to be distributed currently to all beneficiaries.

(c) The phrase *the amount of income for the taxable year required to be distributed currently* includes any amount required to be paid out of income or corpus to the extent the amount is satisfied out of income for the taxable year. Thus, an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently to the extent there is income (as defined in section 643(b)) not paid, credited, or required to be distributed to other beneficiaries for the taxable year. If an annuity or a portion of an annuity is deemed under this paragraph to be income required to be distributed currently, it is treated in all respects in the same manner as an amount of income actually required to be distributed currently. The phrase *the amount of income for the taxable year required to be distributed currently* also includes any amount required to be paid during the taxable year in all events (either out of income or corpus) pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate to the extent there is income (as defined in section 643(b)) of the estate for the taxable year not paid, credited, or required to be distributed to other beneficiaries.

(d) If an annuity is paid, credited, or required to be distributed tax free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be treated as income paid, credited, or required to be distributed currently to the extent it is made out of income.

(e) The application of the rules stated in this section may be illustrated by the following examples:

Example 1. (1) Assume that under the terms of the trust instrument $5,000 is to be paid to X charity out of income each year; that $20,000 of income is currently distributable to A; and that an annuity of $12,000 is to be paid to B out of income or corpus. All expenses are charges against income and capital gains are allocable to corpus. During the taxable year the trust had income of $30,000 (after the payment of expenses) derived from taxable interest and made the payments to X charity and distributions to A and B as required by the governing instrument.

(2) The amounts treated as distributed currently under section 662(a)(1) total $25,000 ($20,000 to A and $5,000 to B). Since the charitable contribution is out of income the amount of income available for B's annuity is only $5,000. The distributable net income of the trust computed under section 643(a) without taking into consideration the charitable contributions deduction of $5,000 as provided by section 661(a)(1), is $30,000. Since the amounts treated as distributed currently of $25,000 do not exceed the distributable net income (as modified) of $30,000, A is required to include $20,000 in his gross income and B is required to include $5,000 in his gross income under section 662(a)(1).

Example 2. Assume the same facts as in paragraph (1) of example 1, except that the trust has, in addition, $10,000 of administration expenses, commissions, etc., chargeable to corpus. The amounts treated as distributed currently under section 662(a)(1) total $25,000 ($20,000 to A and $5,000 to B), since trust income under section 643(b) remains the same as in example 1. Distributable net income of the trust computed under section 643(a) but without taking into account the charitable contributions deduction of $5,000 as provided by section 662(a)(1) is only $20,000. Since the amounts treated as distributed currently of $25,000 exceed the distributable net income (as so computed) of $20,000, A is required to include $16,000 (20,000/25,000 of $20,000) in his gross income and B is required to include $4,000 (5,000/25,000 of $20,000) in his gross income under section 662(a)(1). Because A and B are beneficiaries of amounts of income required to be distributed currently, they do not benefit from the reduction of distributable net income by the charitable contributions deduction.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26912, Sept. 27, 1973]

§ 1.662(a)–3 Other amounts distributed.

(a) There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)–2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

(b) Some of the payments to be included under paragraph (a) of this section are: (1) A distribution made to a beneficiary in the discretion of the fiduciary; (2) a distribution required by the terms of the governing instrument upon the happening of a specified event; (3) an annuity which is required to be paid in all events but which is payable only out of corpus; (4) a distribution of property in kind (see paragraph (f) of § 1.661(a)–2); (5) an amount applied or distributed for the support of a dependent of a grantor or a trustee or cotrustee under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year; and (6) an amount required to be paid during the taxable year pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate which is payable only out of corpus of the estate under the order or decree or local law.

(c) If the sum of the amounts of income required to be distributed currently (as determined under § 1.662(a)–2) and other amounts properly paid, credited, or required to be distributed (as determined under paragraph (a) of this section) exceeds distributable net income (as defined in section 643(a)), then such other amounts properly paid, credited, or required to be distributed are included in gross income of the beneficiary but only to the extent of the excess of such distributable net income over the amounts of income required to be distributed currently. If the other amounts are paid, credited, or required to be distributed to more than one beneficiary, each beneficiary includes in gross income his proportionate share of the amount includible in gross income pursuant to the preceding sentence. The proportionate share is an amount which bears the same ratio to distributable net income (reduced by amounts of income required to be distributed currently) as the other amounts (as determined under paragraphs (a) and (d) of this section) distributed to the beneficiary bear to the other amounts distributed to all beneficiaries. For treatment of excess distributions by trusts, see sections 665 to 668, inclusive, and the regulations thereunder.

(d) The application of the rules stated in this section may be illustrated by the following example:

Example. The terms of a trust require the distribution annually of $10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has $20,000 of income after the deduction of all expenses. Distributable net income is $20,000. The trustee distributes $10,000 of income to A. Of the remaining $10,000 of income, he distributes $3,000 each to B, C, and D, and also distributes an additional $5,000 to A. A includes $10,000 in income under section 662(a)(1). The ''other amounts distributed'' amount of $14,000, includible in the income of the recipients to the extent of $10,000, distributable net income less the income currently distributable to A. A will include an additional $3,571 (5,000/14,000×$10,000) in income under this section, and B, C, and D will each include $2,143 (3,000/14,000×$10,000).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26913, Sept. 27, 1973]

§ 1.662(a)–4 Amounts used in discharge of a legal obligation.

Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a) (1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term *legal obligation* includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a ''legal obligation'' within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

§ 1.662(b)–1 Character of amounts; when no charitable contributions are made.

In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)–1 through 1.662(a)–4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)–1 shall apply.

§ 1.662(b)–2 Character of amounts; when charitable contributions are made.

When a charitable contribution is made, the principles contained in §§ 1.652(b)–1 and 1.662(b)–1 generally apply. However, before the allocation of other deductions among the items of distributable net income, the charitable contributions deduction allowed under section 642(c) is (in the absence of specific allocation under the terms of the governing instrument or the requirement under local law of a different allocation) allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of § 1.643(a)–5. In the application of the preceding sentence, for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently. The application of this section may be illustrated by the following examples (of which example (1) is illustrative of the preceding sentence):

Example 1. (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.

(b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).

(c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.

(d) Under section 662(a)(1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.

(e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.

(f) See subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

Example 2. The net income of a trust is payable to A for life, with the remainder to a charitable organization. Under the terms of the trust instrument and local law capital gains are added to corpus. During the taxable year the trust receives dividends of $10,000 and realized a long-term capital gain of $10,000, for which a long-term capital gain deduction of $5,000 is allowed under section 1202. Since under the trust instrument and local law the capital gains are allocated to the charitable organization, and since the capital gain deduction is directly attributable to the capital gain, the charitable contributions deduction and the capital gain deduction are both allocable to the capital gain, and dividends in the amount of $10,000 are allocable to A.

§ 1.662(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of an estate or trust, the amount he is required to include in gross income in accordance with section 662 (a) and (b) is based upon the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust ending with or within his taxable year. This rule applies as to so-called short taxable years as well as taxable years of normal duration. Income of an estate or trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.662(c)–2 Death of individual beneficiary.

If an amount specified in section 662(a) (1) or (2) is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 662 for the taxable year of the estate or trust in which his last taxable year ends. Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)–3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

§ 1.662(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 662(a) in its gross income for the last taxable year is computed with reference to §§ 1.662(c)–1 and 1.662(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.662(c)–4 Illustration of the provisions of sections 661 and 662.

The provisions of sections 661 and 662 may be illustrated in general by the following example:

Example. (a) Under the terms of a testamentary trust one-half of the trust income is to be distributed currently to W, the decedent's wife, for her life. The remaining trust income may, in the trustee's discretion, either be paid to D, the grantor's daughter, paid to designated charities, or accumulated. The trust is to terminate at the death of W and the principal will then be payable to D. No provision is made in the trust instrument with respect to depreciation of rental property. Capital gains are allocable to the principal account under the applicable local law. The trust and both beneficiaries file returns on the calendar year basis. The records of the fiduciary show the following items of income and deduction for the taxable year 1955:

Rents	$50,000
Dividends of domestic corporations	50,000
Tax-exempt interest	20,000
Partially tax-exempt interest	10,000
Capital gains (long term)	20,000
Depreciation of rental property	10,000
Expenses attributable to rental income	15,400
Trustee's commissions allocable to income account	2,800
Trustee's commissions allocable to principal account	1,100

(b) The income for trust accounting purposes is $111,800, and the trustee distributes one-half ($55,900) to W and in his discretion makes a contribution of one-quarter ($27,950) to charity X and distributes the remaining one-quarter ($27,950) to D. The total of the distributions to beneficiaries is $83,850, consisting of (1) income required to be distributed currently to W of $55,900 and (2) other amounts properly paid or credited to D of $27,950. The income for trust accounting purposes of $111,800 is determined as follows:

Rents		$50,000
Dividends		50,000
Tax-exempt interest		20,000
Partially tax-exempt interest		10,000
Total		130,000
Less:		
Rental expenses	$15,400	
Trustee's commissions allocable to income account	2,800	
		18,200
Income as computed under section 643(b)	111,800	

(c) The distributable net income of the trust as computed under section 643(a) is $82,750, determined as follows:

Rents			$50,000
Dividends			50,000
Partially tax-exempt interest			10,000
Tax-exempt interest		$20,000	
Less:			
Trustee's commissions allocable thereto (20,000/130,000 of $3,900)	$600		
Charitable contributions allocable thereto (20,000/130,000 of $27,950)	4,300		
		4,900	
			15,100
Total			125,100
Deductions:			
Rental expenses		15,400	
Trustee's commissions ($3,900 less $600 allocated to tax-exempt interest)		3,300	
Charitable deduction ($27,950 less $4,300 attributable to tax-exempt interest)		23,650	
			42,350
Distributable net income			82,750

In computing the distributable net income of $82,750, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to beneficiaries and for personal exemption of the trust (section 643(a) (1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); and the tax-exempt interest (as adjusted for expenses and charitable contributions) and the dividend exclusion of $50 were included (section 643(a) (5) and (7)).

(d) Inasmuch as the distributable net income of $82,750 as determined under section 643(a) is less than the sum of the amounts distributed to W and D of $83,850, the deduction allowable to the trust under section 661(a) is such distributable net income as modified under section 661(c) to exclude therefrom the items of income not included in the gross income of the trust, as follows:

Distributable net income		$82,750
Less:		
Tax-exempt interest (as adjusted for expenses and the charitable contributions)	$15,100	
Dividend exclusion allowable under section 116	50	

	15,150
Deduction allowable under section 661(a)	67,600

(e) For the purpose of determining the character of the amounts deductible under section 642(c) and section 661(a), the trustee elected to offset the trustee's commissions (other than the portion required to be allocated to tax-exempt interest) against the rental income. The following table shows the determination of the character of the amounts deemed distributed to beneficiaries and contributed to charity.

	Rents	Taxable dividends	Excluded dividends	Tax exempt interest	Partially tax exempt interest	Total
Trust income	$50,000	$49,950	$50	$20,000	$10,000	$130,000
Less:						
Charitable contribution	10,750	10,750		4,300	2,150	27,950
Rental expenses	15,400					15,400
Trustee's commissions	3,300			600		3,900
Total deductions	29,450	10,750	0	4,900	2,150	47,250
Amounts distributable to beneficiaries	20,550	39,200	50	15,100	7,850	82,750

The character of the charitable contribution is determined by multiplying the total charitable contribution ($27,950) by a fraction consisting of each item of trust income, respectively, over the total trust income, except that no part of the dividends excluded from gross income are deemed included in the charitable contribution. For example, the charitable contribution is deemed to consist of rents of $10,750 (50,000/130,000× $27,950).

(f) The taxable income of the trust is $9,900 determined as follows:

Rental income		$50,000
Dividends ($50,000 less $50 exclusion)		49,950
Partially tax-exempt interest		10,000
Capital gains		20,000
Gross income		129,950
Deductions:		
Rental expenses	15,400	
Trustee's commissions	3,300	
Charitable contributions	23,650	
Capital gain deduction	10,000	
Distributions to beneficiaries	67,600	
Personal exemption	100	
		120,050
Taxable income		9,900

(g) In computing the amount includible in W's gross income under section 662(a)(1), the $55,900 distribution to her is deemed to be composed of the following proportions of the items of income deemed to have been distributed to the beneficiaries by the trust (see paragraph (e) of this example):

Rents (20,550/82,750×$55,900)	$13,882
Dividends (39,250/82,750×$55,900)	26,515
Partially tax-exempt interest (7,850/82,750×$55,900)	5,303
Tax-exempt interest (15,100/82,750×$55,900)	10,200
Total	55,900

Accordingly, W will exclude $10,200 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-half of the total depreciation deduction, or $5,000.

(h) Inasmuch as the sum of the amount of income required to be distributed currently to W ($55,900) and the other amounts properly paid, credited, or required to be distributed to D ($27,950) exceeds the distributable net income ($82,750) of the trust as determined under section 643(a), D is deemed to have received $26,850 ($82,750 less $55,900) for income tax purposes. The character of the amounts deemed distributed to her is determined as follows:

Rents (20,550/82,750×$26,850)	$6,668
Dividends (39,250/82,750×$26,850)	12,735
Partially tax-exempt interest (7,850/82,750×$26,850)	2,547
Tax-exempt interest (15,100/82,750×$26,850)	4,900
Total	26,850

Accordingly, D will exclude $4,900 of tax-exempt interest from gross income and will receive the crddits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-fourth of the total depreciation deduction, or $2,500.

(i) [Reserved]

(j) The remaining $2,500 of the depreciation deduction is allocated to the amount distributed to charity X and is hence non-deductible by the trust, W, or D. (See § 1.642(e)–1.)

§ 1.663(a)–1 Special rules applicable to sections 661 and 662; exclusions; gifts, bequests, etc.

(a) *In general.* A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) *Definition of a gift or bequest of a specific sum of money or of specific property*. (1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's ''adjusted gross estate'' is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example 1. Under the terms of a will, a legacy of $5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of $5,000 in a lump sum to A, transferred the X company stock to W, and made no other distributions to beneficiaries. The distributions to A and W qualify for the exclusion under section 663(a)(1).

Example 2. Under the terms of a will, the testator's estate was to be distributed to A. No provision was made in the will for the distribution of the estate's income during the period of administration. The estate had income of $50,000 for the taxable year. The estate distributed to A stock with a basis of $40,000 and with a fair market value of $40,000 on the date of distribution. No other distributions were made during the year. The distribution does not qualify for the exclusion under section 663(a)(1), because it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a distribution within the meaning of sections 661(a) and 662(a) (see § 1.661(a)–2(c)).

Example 3. Under the terms of a trust instrument, trust income is to be accumulated for a period of 10 years. During the eleventh year, the trustee is to distribute $10,000 to B, payable from income or corpus, and $10,000 to C, payable out of accumulated income. The trustee is to distribute the balance of the accumulated income to A. Thereafter, A is to receive all the current income until the trust terminates. Only the distribution to B would qualify for the exclusion under section 663(a)(1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments.* (1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments:

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of § 1.661(a)–2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) Under the terms of a decedent's will, $10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, $10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, $25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and $50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The $10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The $10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663(a)(1). The situation as to the estate, however, would not be changed.

Example (3). A trust instrument provides that A and B are each to receive $75,000 in installments of $25,000, to be paid in alternate years. The trustee distributes $25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663(a)(1), although a total of six payments is made. The gifts of $75,000 to each beneficiary are to be separately treated.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8849, 64 FR 72543, Dec. 28, 1999]

§ 1.663(a)–2 Charitable, etc., distributions.

Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income and private foundations).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.663(a)–3 Denial of double deduction.

No amount deemed to have been distributed to a beneficiary in a preceding year under section 651 or 661 is included in amounts falling within section 661(a) or 662(a). For example, assume that all of the income of a trust is required to be distributed currently to beneficiary A and both the trust and A report on the calendar year basis. For administrative convenience, the trustee distributes in January and February 1956 a portion of the income of the trust required to be distributed in 1955. The portion of the income for 1955 which was distributed by the trust in 1956 may not be claimed as a deduction by the trust for 1956 since it is deductible by the trust and includible in A's gross income for the taxable year 1955.

§ 1.663(b)–1 Distributions in first 65 days of taxable year; scope.

(a) *Taxable years beginning after December 31, 1968*—(1) *General rule.* With respect to taxable years beginning after December 31, 1968, the fiduciary of a trust may elect under section (b) to 663 treat any amount or portion thereof that is properly paid or credited to a beneficiary within the first 65 days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year.

(2) *Effect of election.* (i) An election is effective only with respect to the taxable year for which the election is made. In the case of distributions made after May 8, 1972, the amount to which the election applies shall not exceed:

(a) The amount of income of the trust (as defined in § 1.643(b)–1) for the taxable year for which the election is made, or

(b) The amount of distributable net income of the trust (as defined in §§ 1.643(a)–1 through 1.643(a)–7) for such taxable year, if greater,

reduced by any amounts paid, credited, or required to be distributed in such taxable year other than those amounts considered paid or credited in a preceding taxable year by reason of section 663(b) and this section. An election shall be made for each taxable year for which the treatment is desired. The application of this paragraph may be illustrated by the following example:

Example. X Trust, a calendar year trust, has $1,000 of income (as defined in § 1.643(b)–1) and $800 of distributable net income (as defined in §§ 1.643(a)–1 through 1.643(a)–7) in 1972. The trust properly pays $550 to A, a beneficiary, on January 15, 1972, which the trustee elects to treat under section 663(b) as paid on December 31, 1971. The trust also properly pays to A $600 on July 19, 1972, and $450 on January 17, 1973. For 1972, the maximum amount that may be elected under this subdivision to be treated as properly paid or credited on the last day of 1972 is $400 ($1,000 − $600). The $550 paid on January 15, 1972, does not reduce the maximum amount to which the election may apply, because that amount is treated as properly paid on December 31, 1971.

(ii) If an election is made with respect to a taxable year of a trust, this section shall apply only to those amounts which are properly paid or credited within the first 65 days following such year and which are so designated by the fiduciary in his election. Any amount considered under section 663(b) as having been distributed in the preceding taxable year shall be so treated for all purposes. For example, in determining the beneficiary's tax liability, such amount shall be considered as having been received by the beneficiary in his taxable year in which or with which the last day of the preceding taxable year of the trust ends.

(b) *Taxable years beginning before January 1, 1969.* With respect to taxable years of a trust beginning before January 1, 1969, the fiduciary of the trust may elect under section 663(b) to treat distributions within the first 65 days following such taxable year as amounts which were paid or credited on the last day of such taxable year, if:

(1) The trust was in existence prior to January 1, 1954;

(2) An amount in excess of the income of the immediately preceding taxable year may not (under the terms of the governing instrument) be distributed in any taxable year; and

(3) The fiduciary elects (as provided in § 1.663(b)–2) to have section 663(b) apply.

[T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§ 1.663(b)–2 Election.

(a) *Manner and time of election; irrevocability*—(1) *When return is required to be filed.* If a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return. The election under this subparagraph shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it.

(2) *When no return is required to be filed.* If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office with which a return by such trust would be filed if such trust were required to file a return for such taxable year. See section 6091 and the regulations thereunder for place for filing returns. The election under this subparagraph shall be made not later than the time prescribed by law for filing a return if such trust were required to file a return for such taxable year. Such election shall become irrevocable after the last day prescribed for making it.

(b) *Elections under prior law.* Elections made pursuant to section 663(b) prior to its amendment by section 331(b) of the Tax Reform Act of 1969 (83 Stat. 598), which, under prior law, were irrevocable for the taxable year for which the election was made and all subsequent years, are not effective for taxable years beginning after December 31, 1968. In the case of a trust for which an election was made under prior law, the fiduciary shall make the election for each taxable year beginning after December 31, 1968, for which the treatment provided by section 663(b) is desired.

[T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§ 1.663(c)–1 Separate shares treated as separate trusts or as separate estates; in general.

(a) If a single trust (or estate) has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts (or estates) for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts (or estates). In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663(c) does not affect the principles of applicable law in situations in which a single trust (or estate) instrument creates not one but several separate trusts (or estates), as opposed to separate shares in the same trust (or estate) within the meaning of this section.

(b) The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:

(1) The filing of returns and payment of tax,

(2) The deduction of personal exemption under section 642(b), and

(3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

(c) The separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required.

(d) Separate share treatment is not elective. Thus, if a trust (or estate) is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the trust (or estate) instrument and the requirements of proper administration require different treatment.

[T. D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, as amended by T.D. 8849, 64 FR 72543, Dec. 28, 1999]

§ 1.663(c)–2 Rules of administration.

(a) *When separate shares come into existence.* A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists.

(b) *Computation of distributable net income for each separate share*—(1) *General rule.* The amount of distributable net income for any share under section 663(c) is computed as if each share constituted a separate trust or estate. Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

(2) *Section 643(b) income.* This paragraph (b)(2) governs the allocation of the portion of gross income includible in distributable net income that is income within the meaning of section 643(b). Such gross income is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

(3) *Income in respect of a decedent.* This paragraph (b)(3) governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent within the meaning of section 691(a) and is not income within the meaning of section 643(b). Such gross income is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

(4) *Gross income not attributable to cash.* This paragraph (b)(4) governs the allocation of the portion of gross income includible in distributable net income that is not attributable to cash

received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items). Such gross income is allocated among the separate shares in the same proportion as section 643(b) income from the same source would be allocated under the terms of the governing instrument or applicable local law.

(5) *Deductions and losses.* Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate.

(c) *Computations and valuations.* For purposes of calculating distributable net income for each separate share, the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations required by paragraph (b) of this section.

[T.D. 8849, 64 FR 72543, Dec. 28, 1999]

§ 1.663(c)–3 Applicability of separate share rule to certain trusts.

(a) The applicability of the separate share rule provided by section 663(c) to trusts other than qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

(b) Separate share treatment will not be applied to a trust or portion of a trust subject to a power to: (1) Distribute, apportion, or accumulate income, or (2) distribute corpus to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

(c) A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

(d) Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

(e) For taxable years ending before December 31, 1978, the separate share rule may also be applicable to successive interests in point of time, as for instance in the case of a trust providing for a life estate to A and a second life estate or outright remainder to B. In such a case, in the taxable year of a trust in which a beneficiary dies items of income and deduction properly allocable under trust accounting principles to the period before a beneficiary's death are attributed to one share, and those allocable to the period after the beneficiary's death are attributed to the other share. Separate share treatment is not available to a succeeding interest, however, with respect to distributions which would otherwise be deemed distributed in a taxable year of the earlier interest under the throwback provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. The application of this paragraph may be illustrated by the following example:

Example. A trust instrument directs that the income of a trust is to be paid to A for her life. After her death income may be distributed to B or accumulated. A dies on June 1, 1956. The trust keeps its books on the basis of the calendar year. The trust instrument permits invasions of corpus for the benefit of A and B, and an invasion of corpus was in fact made for A's benefit in 1956. In determining the distributable net income of the trust for the purpose of determining the amounts includible in A's income, income and deductions properly allocable to the period before A's death are treated as income and deductions of a separate share; and for that purpose no account is taken of income and deductions allocable to the period after A's death.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7633, 44 FR 57926, Oct. 9, 1979; T.D. 8849, 64 FR 72543, Dec. 28, 1999]

§ 1.663(c)–4 Applicability of separate share rule to estates and qualified revocable trusts.

(a) *General rule.* The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

(b) *Special rule for certain types of beneficial interests.* Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

(c) *Shares with multiple beneficiaries and beneficiaries of multiple shares.* A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share.

[T.D. 8849, 64 FR 72544, Dec. 28, 1999]

§ 1.663(c)–5 Examples.

Section 663(c) may be illustrated by the following examples:

Example 1. (i) A single trust was created in 1940 for the benefit of A, B, and C, who were aged 6, 4, and 2, respectively. Under the terms of the instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income is to be accumulated until he becomes 21 years of age. When a beneficiary reaches the age of 21, his share of the income may thereafter be either accumulated or distributed to him in the discretion of the trustee. The trustee also has discretion to invade corpus for the benefit of any beneficiary to the extent of his share of the trust estate, and the trust instrument requires that the beneficiary's right to future income and corpus will be proportionately reduced. When each beneficiary reaches 35 years of age, his share of the trust estate shall be paid over to him. The interest in the trust estate of any beneficiary dying without issue and before he has attained the age of 35 is to be equally divided between the other beneficiaries of the trust. All expenses of the trust are allocable to income under the terms of the trust instrument.

(ii) No distributions of income or corpus were made by the trustee prior to 1955, although A became 21 years of age on June 30, 1954. During the taxable year of 1955, the trust has income from royalties of $20,000 and expenses of $5,000. The trustee in his discretion distributes $12,000 to A. Both A and the trust report on the calendar year basis.

(iii) The trust qualifies for the separate share treatment under section 663(c) and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under section 661 and the amount includible in A's gross income under section 662.

(iv) The distributable net income of each share of the trust is $5,000 ($6,667 less $1,667). Since the amount ($12,000) distributed to A during 1955 exceeds the distributable net income of $5,000 allocated to his share, the trust is deemed to have distributed to him $5,000 of 1955 income and $7,000 of amounts other than 1955 income. Accordingly, the trust is allowed a deduction of $5,000 under section 661. The taxable income of the trust for 1955 is $9,900, computed as follows:

Royalties	$20,000	
Deductions:		
Expenses	$5,000	
Distribution to A	5,000	
Personal exemption	100	
		10,100
Taxable income		9,900

(v) In accordance with section 662, A must include in his gross income for 1955 an amount equal to the portion ($5,000) of the distributable net income of the trust allocated to his share. Also, the excess distribution of $7,000 made by the trust is subject to the throwback provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, and the regulations thereunder.

Example 2. (i) *Facts.* Testator, who dies in 2000, is survived by a spouse and two children. Testator's will contains a fractional formula bequest dividing the residuary estate between the surviving spouse and a trust for the benefit of the children. Under the fractional formula, the marital bequest constitutes 60% of the estate and the children's trust constitutes 40% of the estate. During the year, the executor makes a partial proportionate distribution of $1,000,0000, ($600,000 to the surviving spouse and $400,000 to the children's trust) and makes no other distributions. The estate receives dividend income of $20,000, and pays expenses of $8,000 that are deductible on the estate's federal income tax return.

(ii) *Conclusion.* The fractional formula bequests to the surviving spouse and to the children's trust are separate shares. Because Testator's will provides for fractional formula residuary bequests, the income and any appreciation in the value of the estate assets are proportionately allocated between the marital share and the trust's share. Therefore, in determining the distributable net income of each share, the income and expenses must be allocated 60% to the marital share and 40% to the trust's share. The distributable net income is $7,200 (60% of income less 60% of expenses) for the marital share and $4,800 (40% of income less 40% of expenses) for the trust's share. Because the amount distributed in partial satisfaction of each bequest exceeds the distributable net income of each share, the estate's distribution deduction under section 661 is limited to the sum of the distributable net income for both shares. The estate is allowed a distribution deduction of $12,000 ($7,200 for the marital share and $4,800 for the trust's share). As a result, the estate has zero taxable income ($20,000 income less $8,000 expenses and $12,000 distribution deduction). Under section 662, the surviving spouse and the trust must include in gross income $7,200 and $4,800, respectively.

Example 3. The facts are the same as in *Example 2,* except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

Example 4. (i) *Facts.* Testator, who dies in 2000, is survived by a spouse and one child. Testator's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the benefit of the child of the largest amount that can pass free of Federal estate tax and a bequest of the residuary to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the 2000 taxable year, the estate receives dividend income of $200,000 and pays expenses of $15,000 that are deductible on the estate's federal income tax return. The executor partially funds the child's trust by distributing to it securities that have an adjusted basis to the estate of $350,000 and a fair market value of $380,000 on the date of distribution. As a result of this distribution, the estate realizes long-term capital gain of $30,000.

(ii) *Conclusion.* The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that trust's share is zero. Therefore, with respect to the $380,000 distribution to the child's trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662. Because no distributions were made to the spouse, there is no need to compute the distributable net income allocable to the marital share. The taxable income of the estate for the 2000 taxable year is $214,400 ($200,000 (dividend income) plus $30,000 (capital gain) minus $15,000 (expenses) and minus $600 (personal exemption)).

Example 5. The facts are the same as in *Example 4,* except that during 2000 the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K–1s to the estate by the S corporation and by the partnership, respectively. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share. Therefore, with respect to the $380,000 distribution to the trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662.

Example 6. The facts are the same as in *Example 4,* except that during 2000 the estate receives a distribution of $900,000 from the decedent's individual retirement account that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire $900,000 is allocated to corpus under applicable local law. Both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with the proceeds from the individual retirement account. Therefore, a portion of the $900,000 gross income must be allocated to the trust's separate share. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a deduction under section 661 for the portion of the $900,000 properly allocated to the trust's separate share, and the trust must include this amount in income under section 662.

Example 7. (i) *Facts.* Testator, who dies in 2000, is survived by a spouse and three adult children. Testator's will divides the residue of the estate equally among the three children. The surviving spouse files an election under the applicable state's elective share statute. Under this statute, a surviving spouse is entitled to one-third of the decedent's estate after the payment of debts and expenses. The statute also provides that the surviving spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation of the estate's assets. However, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the payment until the executor actually makes payment. During the estate's 2001 taxable year, the estate distributes to the surviving spouse $5,000,000 in partial satisfaction of the elective share and pays $200,000 of interest on the delayed payment of the elective share. During that year, the estate receives dividend income of $3,000,000 and pays expenses of $60,000 that are deductible on the estate's federal income tax return.

(ii) *Conclusion.* The estate has four separate shares consisting of the surviving spouse's elective share and each of the three children's residuary bequests. Because the surviving spouse is not entitled to any estate income under state law, none of the estate's gross income is allocated to the spouse's separate share for purposes of determining that share's distributable net income. Therefore, with respect to the $5,000,000 distribution, the estate is allowed no deduction under section 661, and no amount is included in the spouse's gross income under section 662. The $200,000 of interest paid to the spouse must be included in the spouse's gross income under section 61. Because no distributions were made to any other beneficiaries during the year, there is no need to compute the distributable net income of the other three separate shares. Thus, the taxable income of the estate for the 2000 taxable year is $2,939,400 ($3,000,000 (dividend income) minus $60,000 (expenses) and $600 (personal exemption)). The estate's $200,000 interest payment is a nondeductible personal interest expense described in section 163(h).

Example 8. The will of Testator, who dies in 2000, directs the executor to distribute the X stock and all dividends therefrom to child A and the residue of the estate to child B. The estate has two separate shares consisting of the income on the X stock bequeathed to A and the residue of the estate bequeathed to B. The bequest of the X stock meets the definition of section 663(a)(1) and therefore is not a separate share. If any distributions, other than shares of the X stock, are made during the year to either A or B, then for purposes of determining the distributable net income for the separate shares, gross income attributable to dividends on the X stock must be allocated to A's separate share and any other income must be allocated to B's separate share.

Example 9. The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is $9,000,000. During 2000, the $900,000 balance in Testator's individual retirement account is distributed to the estate. The entire $900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the $900,000 of income in respect of a decedent must be allocated to A's share.

Example 10. The facts are the same as in *Example 9*, except that the will directs the executor to fund A's share first with X stock valued at $3,000,000, rather than with the proceeds of the individual retirement account. The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the $900,000 of gross income attributable to the proceeds from the individual retirement account must be allocated between the two shares to the extent that they could potentially be funded with those proceeds. The maximum amount of A's share that could potentially be funded with the income in respect of decedent is $1,500,000 ($4,500,000 value of share less $3,000,000 to be funded with stock) and the maximum amount of B's share that could potentially be funded with income in respect of decedent is $4,500,000. Based upon the relative values of these amounts, the gross income attributable to the proceeds of the individual retirement account is allocated $225,000 (or one-fourth) to A's share and $675,000 (or three-fourths) to B's share.

Example 11. The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 8849, 64 FR 72543, 72544, Dec. 28, 1999; 65 FR 16317, Mar. 28, 2000]

§ 1.663(c)–6 Effective dates.

Sections 1.663(c)–1 through 1.663(c)–5 are applicable for estates and qualified revocable trusts within the meaning of section 645(b)(1) with respect to decedents who die on or after December 28, 1999. However, for estates and qualified revocable trusts with respect to decedents who died after the date that section 1307 of the Tax Reform Act of 1997 became effective but before December 28, 1999, the IRS will accept any reasonable interpretation of the separate share provisions, including those provisions provided in 1999–11 I.R.B. 41 (see § 601.601(d)(2)(ii)(b) of this chapter). For trusts other than qualified revocable trusts, § 1.663(c)–2 is applicable for taxable years of such trusts beginning after December 28, 1999.

[T.D. 8849, 64 FR 72545, Dec. 28, 1999; 65 FR 16317, Mar. 28, 2000]

§ 1.664–1 Charitable remainder trusts.

(a) *In general*—(1) *Introduction*—(i) *General description of a charitable remainder trust.* Generally, a charitable remainder trust is a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity. The specified distribution to be paid at least annually must be a sum certain which is not less than 5 percent of the initial net fair market value of all property placed in trust (in the case of a charitable remainder annuity trust) or a fixed percentage which is not less than 5 percent of the net fair market value of the trust assets, valued annually (in the case of a charitable remainder unitrust). A trust created after July 31, 1969, which is a charitable remainder trust is exempt from all of the taxes imposed by subtitle A of the Code for any taxable year of the trust except a taxable year in which it has unrelated business taxable income.

(ii) *Scope.* This section provides definitions, general rules governing the creation and administration of a charitable remainder trust, and rules governing the taxation of the trust and its beneficiaries. For the application of certain foundation rules to charitable remainder trusts, see paragraph (b) of this section. If the trust has unrelated business taxable income, see paragraph (c) of this section. For the treatment of distributions to recipients, see paragraph (d) of this section. For the treatment of distributions to charity, see paragraph (e) of this section. For the time limitations for amendment of governing instruments, see paragraph (f) of this section. For transitional rules under which particular requirements are inapplicable to certain trusts, see paragraph (g) of this section. Section 1.664–2 provides rules relating solely to a charitable remainder annuity trust. Section 1.664–3 provides rules relating solely to a charitable remainder unitrust. Section 1.664–4 provides rules governing the calculation of the fair market value of the remainder interest in a charitable remainder unitrust. For rules relating to the filing of returns for a charitable remainder trust, see paragraph (a)(6) of §1.6012–3 and section 6034 and the regulations thereunder.

(iii) *Definitions.* As used in this section and §§1.664–2, 1.664–3, and 1.664–4:

(a) Charitable remainder trust. The term *charitable remainder trust* means a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522 and which meets the description of a charitable remainder annuity trust (as described in §1.664–2) or a charitable remainder unitrust (as described in §1.664–3).

(b) Annuity amount. The term *annuity amount* means the amount described in paragraph (a)(1) of §1.664–2 which is payable, at least annually, to the beneficiary of a charitable remainder annuity trust.

(c) Unitrust amount. The term *unitrust amount* means the amount described in paragraph (a)(1) of §1.664–3 which is payable, at least annually, to the beneficiary of a charitable remainder unitrust.

(d) Recipient. The term *recipient* means the beneficiary who receives the possession or beneficial enjoyment of the annuity amount or unitrust amount.

(e) Governing instrument. The term *governing instrument* has the same meaning as in section 508(e) and the regulations thereunder.

(2) *Requirement that the trust must be either a charitable remainder annuity trust or a charitable remainder unitrust.* A trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect. For example, a trust which provides for the payment each year to a noncharitable beneficiary of the greater of a sum certain or a fixed percentage of the annual value of the trust assets is not a charitable remainder trust inasmuch as the trust is neither a charitable remainder annuity trust (for the reason that the payment for the year may be a fixed percentage of the annual value of the trust assets which is not a ''sum certain'') nor a charitable remainder unitrust (for the reason that the payment for the year may be a sum certain which is not a ''fixed percentage'' of the annual value of the trust assets).

(3) *Restrictions on investments.* A trust is not a charitable remainder trust if the provisions of the trust include a

provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. In the case of transactions with, or for the benefit of, a disqualified person, see section 4941(d) and the regulations thereunder for rules relating to the definition of self-dealing.

(4) *Requirement that trust must meet definition of and function exclusively as a charitable remainder trust from its creation.* In order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. Solely for the purposes of section 664 and the regulations thereunder, the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code (relating to grantors and others treated as substantial owners), but in no event prior to the time property is first transferred to the trust. For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient. See examples 1 through 3 of subparagraph (6) of this paragraph for illustrations of the foregoing rule.

(5) *Rules applicable to testamentary transfers*—(i) *Deferral of annuity or unitrust amount.* Notwithstanding subparagraph (4) of this paragraph and §§ 1.664–2 and 1.664–3, for purposes of sections 2055 and 2106 a charitable remainder trust shall be deemed created at the date of death of the decedent (even though the trust is not funded until the end of a reasonable period of administration or settlement) if the obligation to pay the annuity or unitrust amount with respect to the property passing in trust at the death of the decedent begins as of the date of death of the decedent, even though the requirement to pay such amount is deferred in accordance with the rules provided in this subparagraph. If permitted by applicable local law or authorized by the provisions of the governing instrument, the requirement to pay such amount may be deferred until the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable period after such time, the trust must pay (in the case of an underpayment) or must receive from the recipient (in the case of an overpayment) the difference between:

(a) Any annuity or unitrust amounts actually paid, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, and

(b) The annuity or unitrust amounts payable, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually.

The amounts payable shall be retroactively determined by using the taxable year, valuation method, and valuation dates which are ultimately adopted by the charitable remainder trust. See subdivision (ii) of this subparagraph for rules relating to retroactive determination of the amount payable under a charitable remainder unitrust. See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient.

(ii) For purposes of retroactively determining the amount under subdivision (i)*(b)* of this subparagraph, the governing instrument of a charitable remainder unitrust may provide that the amount described in subdivision (i)*(b)* of this subparagraph with respect to property passing in trust at the death of the decedent for the period which begins on the date of death of the decedent and ends on the earlier of the date of death of the last recipient or the end of the taxable year of the trust in which occurs the complete funding of the trust shall be computed by multiplying:

(a) The sum of *(1)* the value, on the earlier of the date of death of the last recipient or the last day in such taxable year, of the property held in trust which is attributable to property passing to the trust at the death of the decedent, *(2)* any distributions in respect of unitrust amounts made by the trust

or estate before such date, and *(3)* interest on such distributions computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, from the date of distribution to such date by:

(*b*) (*1*) In the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in Table D in § 1.664–4(e)(6) opposite the number of years in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year.

(*2*) In the case of transfers for which the valuation date is after April 30, 1989, a factor equal to 1.000000 less the factor under the appropriate adjusted payout rate in Table D in § 1.664–4(e)(6) opposite the number of years in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day of such taxable year. The appropriate adjusted payout rate is determined by using the appropriate Table F contained in § 1.664–4(e)(6) for the section 7520 rate for the month of the valuation date.

(*3*) If the number of years between the date of death and the date of the earlier of the death of the last recipient or the last day of such taxable year is between periods for which factors are provided, a linear interpolation must be made.

(iii) *Treatment of distributions.* The treatment of a distribution to a charitable remainder trust, or to a recipient in respect of an annuity or unitrust amount, paid, credited, or required to be distributed by an estate, or by a trust which is not a charitable remainder trust, shall be governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664. In the case of a charitable remainder trust which is partially or fully funded during the period of administration of an estate or settlement of a trust (which is not a charitable remainder trust), the treatment of any amount paid, credited, or required to be distributed by the charitable remainder trust shall be governed by the rules of section 664.

(iv) *Rate of interest.* The following rates of interest shall apply for purposes of paragraphs (a)(5) (i) through (ii) of this section:

(*a*) The section 7520 rate for the month in which the valuation date with respect to the transfer is (or one of the prior two months if elected under § 1.7520–2(b)) after April 30, 1989;

(*b*) 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) on or after August 9, 1984, and before May 1, 1989, and not subsequently amended;

(*c*) 6 percent or 10 percent for instruments executed or amended (other than in the case of a reformation under section 2055(e)(3)) after October 24, 1983, and before August 9, 1984; and

(*d*) 6 percent for instruments executed before October 25, 1983, and not subsequently amended (other than in the case of a reformation under section 2055(e)(3)).

(6) *Examples.* The application of the rules in paragraphs (a)(4) and (a)(5) of this section require the use of actuarial factors contained in §§ 1.664–4(e) and 1.664–4A(d) and (e) and may be illustrated by use of the following examples:

Example (1). On September 19, 1971, H transfers property to a trust over which he retains an inter vivos power of revocation. The trust is to pay W 5 percent of the value of the trust assets, valued annually, for her life, remainder to charity. The trust would satisfy all of the requirements of section 664 if it were irrevocable. For purposes of section 664, the trust is not deemed created in 1971 because H is treated as the owner of the entire trust under subpart E. On May 26, 1975, H predeceases W at which time the trust becomes irrevocable. For purposes of section 664, the trust is deemed created on May 26, 1975, because that is the earliest date on which H is not treated as the owner of the entire trust under subpart E. The trust becomes a charitable remainder trust on May 26, 1975, because it meets the definition of a charitable remainder trust from its creation.

Example (2). The facts are the same as in example (1), except that H retains the inter vivos power to revoke only one-half of the trust. For purposes of section 664, the trust is deemed created on September 19, 1971, because on that date the grantor is not treated as the owner of the entire trust under subpart E. Consequently, a charitable deduction is not allowable either at the creation of the trust or at H's death because the trust does not meet the definition of a charitable remainder trust from the date of its creation. The trust does not meet the definition of a charitable remainder trust from the date of its creation because the trust is subject to a partial power to revoke on such date.

Example (3). The facts are the same as in example (1), except that the residue of H's estate is to be paid to the trust and the trust is required to pay H's debts. The trust is not a charitable remainder trust at H's death because it does not function exclusively as a charitable remainder trust from the date of its creation which, in this case, is the date it becomes irrevocable.

Example (4). (i) In 1971, H transfers property to Trust A over which he retains an inter vivos power of revocation. Trust A, which is not a charitable remainder trust, is to provide income or corpus to W until the death of H. Upon H's death the trust is required by its governing instrument to pay the debts and administration expenses of H's estate, and then to terminate and distribute all of the remaining assets to a separate Trust B which meets the definition of a charitable remainder annuity trust.

(ii) Trust B will be charitable remainder trust from the date of its funding because it will function exclusively as a charitable remainder trust from its creation. For purposes of section 2055, Trust B will be deemed created at H's death if the obligation to pay the annuity amount begins on the date of H's death. For purposes of section 664, Trust B becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless Trust B has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by Trust A, including distributions to a recipient in respect of annuity amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (5). In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses.

For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (6). (i) On January 1, 1974, H dies testate leaving the residue of his estate to a charitable remainder unitrust. The governing instrument provides that, beginning at H's death, the trustee is to make annual payments to W, on December 31 of each year of 5 percent of the net fair market value of the trust assets, valued as of December 31 of each year, for W's life and to pay the remainder to charity at the death of W. The governing instrument also provides that the actual payment of the unitrust amount need not be made until the end of the taxable year of the trust in which occurs the complete funding of the trust. The governing instrument also provides that the amount payable with respect to the period between the date of death and the end of such taxable year shall be computed under the special method provided in subparagraph (5)(ii) of this paragraph. The governing instrument provides that, within a reasonable period after the end of the taxable year of the trust in which occurs the complete funding of the trust, the trustee shall pay (in the case of an underpayment) or shall receive from the recipient (in the case of an overpayment) the difference between the unitrust amounts paid (plus interest at 6 percentage compounded annually) and the amount computed under the special method. The trust is completely funded on September 20, 1976. No amounts were paid before June 30, 1977. The trust adopts a fiscal year of July 1 to June 30. The net fair market value of the trust assets on June 30, 1977, is $100,000.

(ii) Because no amounts were paid prior to the end of the taxable year in which the trust was completely funded, the amount payable at the end of such taxable year is equal to the net fair market value of the trust assets on the last day of such taxable year (June 30, 1977) multiplied by a factor equal to 1.0 minus the factor in Table D corresponding to the number of years in the period between the date of death and the end of such taxable year. The adjusted payout rate (determined under §1.664–4A(c)) is 5 percent. Because the last day of the taxable year in which the trust is completely funded in June 30, 1977, there are 3 181/365 years in such period. Because there is no factor given in Table D for such a period, a linear interpolation must be made:

1.0 minus 0.814506 (factor at 5 percent for 4 years)	0.185494
1.0 minus 0.857375 (factor at 5 percent for 3 years)	.142625
Difference	.042869

$$181 \div 365 = X \div 0.042869$$

$$X = 0.021258$$

1.0 minus 0.857375 (factor at 5 percent for 3 years	0.142625
Plus: X	.021258
Interpolated factor	.163883

Thus, the amount payable for the period from January 1, 1974, to June 30, 1977, is $16,388.30 ($100,000×0.163883). Thereafter, the trust assets must be valued on December 31 of each year and 5 percent of such value paid annually to W for her life.

(7) *Valuation of unmarketable assets*—(i) *In general.* If unmarketable assets are transferred to or held by a trust, the trust will not be a trust with respect to which a deduction is available under section 170, 2055, 2106, or 2522, or will be treated as failing to function exclusively as a charitable remainder trust unless, whenever the trust is required to value such assets, the valuation is—

(*a*) Performed exclusively by an independent trustee; or

(*b*) Determined by a *current qualified appraisal,* as defined in § 1.170A–13(c)(3), from a *qualified appraiser,* as defined in § 1.170A–13(c)(5).

(ii) *Unmarketable assets.* Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

(iii) *Independent trustee.* An independent trustee is a person who is not the grantor of the trust, a noncharitable beneficiary, or a related or subordinate party to the grantor, the grantor's spouse, or a noncharitable beneficiary (within the meaning of section 672(c) and the applicable regulations).

(b) *Application of certain foundation rules to charitable remainder trusts.* See section 4947(a)(2) and section 4947(b)(3)(B) and the regulations thereunder for the application to charitable remainder trusts of certain provisions relating to private foundations. See section 508(e) for rules relating to required provisions in governing instruments prohibiting certain activities specified in section 4947(a)(2).

(c) *Taxation of nonexempt charitable remainder trusts.* If the charitable remainder trust has any unrelated business taxable income (within the meaning of section 512 and the regulations thereunder, determined as if part III, subchapter F, chapter 1, subtitle A of the Code applied to such trust) for any taxable year, the trust is subject to all of the taxes imposed by subtitle A of the Code for such taxable year. For taxable years beginning after December 31, 1969, unrelated business taxable income includes debt-financed income. The taxes imposed by subtitle A of the Code upon a nonexempt charitable remainder trust shall be computed under the rules prescribed by subparts A and C, part 1, subchapter J, chapter 1, subtitle A of the Code for trusts which may accumulate income or which distribute corpus. The provisions of subpart E, part 1 of such subchapter J are not applicable with respect to a nonexempt charitable remainder trust. The application of the above rules may be illustrated by the following example:

Example. In 1975, a charitable remainder trust which has a calendar year as its taxable year has $1,000 of ordinary income, including $100 of unrelated business taxable income, and no deductions other than under sections 642(b) and 661(a). The trust is required to pay out $700 for 1975 to a noncharitable recipient. Because the trust has some unrelated business taxable income in 1975, it is not exempt for such year. Consequently, the trust is taxable on all of its income as a complex trust. Under section 661(a) of the Code, the trust is allowed a deduction of $700. Under section 642(b) of the Code, the trust is allowed a deduction of $100. Consequently, the taxable income of the trust for 1975 is $200 ($1,000 − $700 − $100).

(d) *Treatment of annual distributions to recipients*—(1) *Character of distributions*—(i) *Order of distributions.* Annuity and unitrust amounts shall be treated as having the following characteristics in the hands of the recipients (whether or not the trust is exempt) without credit for any taxes which are imposed by subtitle A of the Code on the trust:

(a) Ordinary income. First, as ordinary income to the extent of the sum of the trust's ordinary income for the

taxable year of the trust and its undistributed ordinary income for prior years. An ordinary loss for the current year shall be used to reduce undistributed ordinary income for prior years and any excess shall be carried forward indefinitely to reduce ordinary income for future years. For purposes of this section, the amount of current and prior years' income shall be computed without regard to the deduction for net operating losses provided by sections 172 or 642(d).

(b) Capital gain. Second, as capital gain to the extent of the trust's undistributed capital gains. Undistributed capital gains of the trust are determined on a cumulative net basis under the rules of this subdivision without regard to the provisions of section 1212.

(1) Long- and short-term capital gains. If, in any taxable year of the trust, the trust has both undistributed short-term capital gain and undistributed long-term capital gain, then the short term capital gain shall be deemed distributed prior to any long-term capital gain.

(2) Capital losses in excess of capital gains. If the trust has for any taxable year capital losses in excess of capital gains, any excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year and any excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(3) Capital gains in excess of capital losses. If the trust has for any taxable year capital gains in excess of capital losses, any excess of the net short-term capital gain over the net long-term capital loss for such year shall be, to the extent not deemed distributed, a short-term capital gain in the succeeding taxable year and any excess of the net long-term capital gain over the net short-term capital loss for such year shall be, to the extent not deemed distributed, a long-term capital gain in the succeeding taxable year.

The application of the rules in this subdivision *(b)* may be illustrated by the following example:

Example. (i) The X Trust is a charitable remainder trust created on January 1, 1975, and has the calendar year as its taxable year. During the years indicated, it has the following capital transactions:

1975:	
Long-term capital loss	$10
Short-term capital gain	5
1976:	
Short-term capital gain	20
Short-term capital loss	5
1977:	
Long-term capital gain	15

Distributions for 1975 and 1976 were not in excess of current and accumulated ordinary income for those years. In 1977, distributions exceeded current and accumulated ordinary income by $5.

(ii) The treatment of the 1975 and 1976 transactions is as follows:

1975:	
Long-term capital loss recognized	$(10)
Short-term capital gain recognized	5
Net long-term capital loss carried forward to 1976	(5)
1976:	
Short-term capital gain recognized	20
Short-term capital loss recognized	(5)
Long-term capital loss carried forward from 1975	(5)
Net short-term capital gain carried forward to 1977	$10
1977:	
Long-term capital gain recognized	15
Net short-term capital gain carried forward from 1976	10

(iii) *Application of section 643(a)(7).* For application of the anti-abuse rule of section 643(a)(7) to distributions from charitable remainder trusts, see § 1.643(a)–8.

(iv) In 1977, the trust has long-term capital gain of $15 and short-term capital gain of $10. If the trust has both short-term capital gain and long-term capital gain for the same taxable year, the short-term capital gain is deemed distributed prior to the long-term capital gain. Therefore, the distribution of $5 in 1977 is deemed to be short-term capital gain. The undistributed net short-term capital gain of $5 is a short-term capital gain carried forward to 1978. The undistributed net long-term capital gain of $15 is a long-term capital gain carried forward to 1978.

(c) Other income. Third, as other income (including income excluded under part III, subchapter B, chapter 1, subtitle A of the Code) to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years. A loss in this category for the current year shall be used to reduce undistributed income in such category for prior years and

any excess shall be carried forward indefinitely to reduce such income for future years.

(d) Corpus. Finally, as a distribution of trust corpus. For purposes of this section, the term *corpus* means the net fair market value of the trust assets less the total undistributed income (but not loss) in each of the above categories.

(ii) *Rules relating to character of distributions.* The determination of the character of amounts distributed shall be made as of the end of the taxable year of the trust. Amounts treated as paid from one of the categories of income described in *(a), (b),* or *(c)* of subdivision (i) of this subparagraph shall be treated as consisting of the same proportion of each class of items included in such category as the total of the current and accumulated income of each class of items bears to the total of the current and accumulated income for that category. A loss in one of such categories may not be used to reduce a gain in any other category. The provisions of subparts D and E, part 1, subchapter J, chapter 1, subtitle A of the Code are not applicable with respect to a charitable remainder trust (regardless of whether the trust is exempt).

(iii) *Application of section 643(a)(7).* For application of the anti–abuse rule of section 643(a)(7) to distributions from charitable remainder trusts, see § 1.643(a)–8.

(iv) *Example.* The following example illustrates the application of this paragraph (d)(1):

Example. (i) *X* is a charitable remainder unitrust described in section 664(d)(2) and (3). The annual unitrust amount is the lesser of the amount of trust income, as defined in § 1.664–3(a)(1)(i)(*b*), or six percent of the net fair market value of the trust assets valued annually. The net fair market value of the trust assets on the valuation date in 1996 is $150,000. During 1996, *X* has $7,500 of income after allocating all expenses. All of *X*'s income for 1996 is tax-exempt income. At the end of 1996, *X*'s ordinary income for the current taxable year and undistributed ordinary income for prior years are both zero; *X*'s capital gain for the current taxable year is zero and undistributed capital gain for prior years is $30,000; and *X*'s tax-exempt income for the current year is $7,500 and undistributed tax-exempt income for prior years is $2,500.

(ii) Because the trust income of $7,500 is less than the fixed percentage amount of $9,000, the unitrust amount for 1996 is $7,500. The character of that amount in the hands of the recipient of the unitrust amount is determined under section 664(b). Because the unitrust amount is less than *X*'s undistributed capital gain income, the recipient of the unitrust amount treats the distribution of $7,500 as capital gain. At the beginning of 1997, *X*'s undistributed capital gain for prior years is reduced to $22,500, and *X*'s undistributed tax-exempt income is increased to $10,000.

(2) *Allocation of deductions.* Items of deduction of the trust for a taxable year of the trust which are deductible in determining taxable income (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) which are directly attributable to one or more classes of items within a category of income or to corpus (determined under subparagraph (1)(i) of this paragraph) shall be allocated to such classes of items or to corpus. All other allowable deductions for such taxable year which are not directly attributable to one or more classes of items within a category of income or to corpus (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) shall be allocated among the classes of items within the category (excluding classes of items with net losses) on the basis of the gross income of such classes for such taxable year reduced by the deductions allocated thereto under the first sentence of this subparagraph, but in no event shall the amount of expenses allocated to any class of items exceed such income of such class for the taxable year. Items of deduction which are not allocable under the above two sentences (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) may be allocated in any manner. All taxes imposed by subtitle A of the Code for which the trust is liable because it has unrelated business taxable income and all taxes imposed by chapter 42 of the Code shall be allocated to corpus. Any expense which is not deductible in determining taxable income and which is not allocable to any class of items described in subparagraph (1)(i)*(c)* of this paragraph shall be allocated to corpus. The deductions allowable to a trust under sections 642(b), 642(c), 661, and

1202 are not allowed in determining the amount or character of any class of items within a category of income or corpus in the categories described in subparagraph (1) of this paragraph.

(3) *Allocation of income among recipients.* If there are two or more recipients, each will be treated as receiving his pro rata portion of the categories of income and corpus. The application of this rule may be illustrated by the following example:

Example. X transfers $40,000 to a charitable remainder annuity trust which is to pay $3,000 per year to X and $2,000 per year to Y for a term of 5 years. During the first taxable year the trust has $3,000 of ordinary income, $500 of capital gain, and $500 of tax-exempt income after allocation of all expenses. X is treated as receiving ordinary income of $1,800 ($3,000/$5,000×$3,000), capital gain of $300 ($3,000/$5,000×$500), tax exempt income of $300 ($3,000/$5,000×$500), and corpus of $600 ($3,000/$5,000×[$5,000−$4,000]). Y is treated as receiving ordinary income of $1,200 ($2,000/$5,000×$3,000), capital gain of $200 ($2,000/$5,000×$500), tax exempt income of $200 ($2,000/$5,000×$500), and corpus of $400 ($2,000/$5,000×[$5,000−$4,000]).

(4) *Year of inclusion*—(i) *General rule.* To the extent required by this paragraph, the annuity or unitrust amount is includible in the recipient's gross income for the taxable year in which the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the taxable year of the trust. If a recipient has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income to the extent required by this paragraph shall be included in his taxable year in which or with which ends the taxable year of the trust in which such amount is required to be distributed.

(ii) *Payments resulting from incorrect valuations.* Notwithstanding subdivision (i) of this subparagraph, any payments which are made or required to be distributed by a charitable remainder trust pursuant to paragraph (a)(5) of this section, under paragraph (f)(3) of this section because of an amendment to the governing instrument, or under paragraphs (a)(1) of §§1.664–2 and 1.664–3 because of an incorrect valuation, shall, to the extent required by this paragraph, be included in the gross income of the recipient in his taxable year in which or with which ends the taxable year of the trust in which the amount is paid, credited, or required to be distributed. For rules relating to required adjustments of underpayments and overpayments of the annuity or unitrust amounts in respect of payments made prior to the amendment of a governing instrument, see paragraph (f)(3) of this section. There is allowable to a recipient a deduction from gross income for any amounts repaid to the trust because of an overpayment during the reasonable period of administration or settlement or until the trust is fully funded, because of an amendment, or because of an incorrect valuation, to the extent such amounts were included in his gross income. See section 1341 and the regulations thereunder for rules relating to the computation of tax where a taxpayer restores substantial amounts held under a claim of right.

(iii) *Rules applicable to year of recipient's death.* If the taxable year of the trust does not end with or within the last taxable year of the recipient because of the recipient's death, the extent to which the annuity or unitrust amount required to be distributed to him is included in the gross income of the recipient for his last taxable year, or in the gross income of his estate, is determined by making the computations required under this paragraph for the taxable year of the trust in which his last taxable year ends. (The last sentence of subdivision (i) of this subparagraph does not apply to such amounts.) The gross income for the last taxable year of a recipient on the cash basis includes (to the extent required by this paragraph) amounts actually distributed to the recipient before his death. Amounts required to be distributed which are distributed to his estate, are included (to the extent required by this paragraph) in the gross income of the estate as income in respect of a decedent under section 691.

(5) *Distributions in kind.* The annuity or unitrust amount may be paid in cash or in other property. In the case

of a distribution made in other property, the amount paid, credited, or required to be distributed shall be considered as an amount realized by the trust from the sale or other disposition of property. The basis of the property in the hands of the recipient is its fair market value at the time it was paid, credited, or required to be distributed. The application of these rules may be illustrated by the following example:

Example. On January 1, 1971, X creates a charitable remainder annuity trust, whose taxable year is the calendar year, under which X is to receive $5,000 per year. During 1971, the trust receives $500 of ordinary income. On December 31, 1971, the trust distributed cash of $500 and a capital asset of the trust having a fair market value of $4,500 and a basis of $2,200. The trust is deemed to have realized a capital gain of $2,300. X treats the distribution of $5,000 as being ordinary income of $500, capital gain of $2,300 and trust corpus of $2,200. The basis of the distributed property is $4,500 in the hands of X.

(e) *Other distributions*—(1) *Character of distributions.* An amount distributed by the trust to an organization described in section 170(c) other than the annuity or unitrust amount shall be considered as a distribution of corpus and of those categories of income specified in paragraph (d)(1) of this section in an order inverse to that prescribed in such paragraph. The character of such amount shall be determined as of the end of the taxable year of the trust in which the distribution is made after the character of the annuity or unitrust amount has been determined.

(2) *Distributions in kind.* In the case of a distribution of an amount to which subparagraph (1) of this paragraph applies, no gain or loss is realized by the trust by reason of a distribution in kind unless such distribution is in satisfaction of a right to receive a distribution of a specific dollar amount or in specific property other than that distributed.

(f) *Effective date*—(1) *General rule.* The provisions of this section are effective with respect to transfers in trust made after July 31, 1969. Any trust created (within the meaning of applicable local law) prior to August 1, 1969, is not a charitable remainder trust even if it otherwise satisfies the definition of a charitable remainder trust.

(2) *Transfers to pre-1970 trusts.* 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, for purposes of subparagraphs (1) and (3) of this paragraph, 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 the transferred property and any undistributed income therefrom is severed and placed in a separate trust before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings begun before December 31, 1972, which are required to sever such property, become final.

(3) *Amendment of post-1969 trusts.* A trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, which is not a charitable remainder trust at the date of its creation, may be treated as a charitable remainder trust from the date it would be deemed created under § 1.664–1(a) (4) and (5)(i) for all purposes: *Provided,* That all the following requirements are met:

(i) At the time of the creation of the trust, the governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust.

(ii) The governing instrument of the trust is amended so that the trust will meet the definition of a charitable remainder trust and, if applicable, will meet the requirement of paragraph (a)(5)(i) of this section that obligation to make payment of the annuity or unitrust amount with respect to property passing at death begin as of the date of death, before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. In the case of a trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, the provisions of section 508(d)(2)(A) shall not apply if the governing instrument of the trust is amended so as to comply with the requirements of section 508(e) before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. Notwithstanding the provisions of paragraphs (a)(3) and (a)(4) of §§ 1.664–2 and 1.664–3, the governing instrument may grant to the trustee a power to amend the governing instrument for the sole purpose of complying with the requirements of this section and § 1.664–2 or § 1.664–3: *Provided,* That at the creation of the trust, the governing instrument *(a)* provides for the payment of a unitrust amount described in § 1.664–3(a)(1)(i) or an annuity which meets the requirements of paragraph (a)(2) of § 1.664–2 or § 1.664–3, *(b)* designates the recipients of the trust and the period for which the amount described in (*a*) of this subdivision (ii) is to be paid, and *(c)* provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust. The mere granting of such a power is not sufficient to meet the requirements of this subparagraph that the governing instrument be amended in the manner and within the time limitations of this subparagraph.

(iii)*(a)* Where the amount of the distributions which would have been made by the trust to a recipient if the amended provisions of such trust had been in effect from the time of creation of such trust exceeds the amount of the distributions made by the trust prior to its amendment, the trust pays an amount equal to such excess to the recipient.

(b) Where the amount of distributions made to the recipient prior to the amendment of the trust exceeds the amount of the distributions which would have been made by such trust if the amended provisions of such trust had been in effect from the time of creation of such trust, such excess is repaid to the trust by the recipient.

See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient. A deduction for a transfer to a charitable remainder trust shall not be allowed until the requirements of this paragraph are met and then only if the deduction is claimed on a timely filed return (including extensions) or on a claim for refund filed within the period of limitations prescribed by section 6511(a).

(4) *Valuation of unmarketable assets.* The rules contained in paragraph (a)(7) of this section are applicable for trusts created on or after December 10, 1998. A trust in existence as of December 10, 1998, whose governing instrument requires that an independent trustee value the trust's unmarketable assets may be amended or reformed to permit a valuation method that satisfies the requirements of paragraph (a)(7) of this section for taxable years beginning on or after December 10, 1998.

(g) *Transitional effective date.* Notwithstanding any other provision of this section, § 1.664–2 or § 1.664–3, the requirement of paragraph (a)(5)(i) of this section that interest accrue on overpayments and underpayments, the requirement of paragraph (a)(5)(ii) of this section that the unitrust amount accruing under the formula provided therein cease with the death of the last recipient, and the requirement that the governing instrument of the trust contain the provisions specified in paragraph (a)(1)(iv) of § 1.664–2 (relating to computation of the annuity amount in certain circumstances), paragraph (a)(1)(v) of § 1.664–3 (relating to computation of the unitrust amount in certain circumstances), paragraphs (b) of §§ 1.664–2 and 1.664–3 (relating to additional contributions), and paragraph (a)(1)(iii) of § 1.664–3 (relating to incorrect valuations), paragraphs (a)(6)(iv) of §§ 1.664–2 and 1.664–3 (relating to alternative remaindermen) shall not apply to:

(1) A will executed on or before December 31, 1972, if:

(i) The testator dies before December 31, 1975, without having republished the will after December 31, 1972, by codicil or otherwise.

(ii) The testator at no time after December 31, 1972, had the right to change the provisions of the will which pertain to the trust, or

(iii) The will is not republished by codicil or otherwise before December 31, 1975, and the testator is on such date and at all times thereafter under a mental disability to republish the will by codicil or otherwise, or

(2) A trust executed on or before December 31, 1972, if:

(i) The grantor dies before December 31, 1975, without having amended the trust after December 31, 1972,

(ii) The trust is irrevocable on December 31, 1972, or

(iii) The trust is not amended before December 31, 1975, and the grantor is on such date and at all times thereafter under a mental disability to change the terms of the trust.

[T.D. 7202, 37 FR 16913, Aug. 23, 1972; 37 FR 28288, Dec. 22, 1972, as amended by T.D. 7955, 49 FR 19983, May 11, 1984; T.D. 8540, 59 FR 30102, 30116, June 10, 1994; T.D. 8791, 63 FR 68191, Dec. 10, 1998; T.D. 8819, 64 FR 23228, 23229, Apr. 30, 1999; T.D. 8886, 65 FR 36943, June 12, 2000; T.D. 8926, 66 FR 1037, Jan. 5, 2001]

§ 1.664–2 Charitable remainder annuity trust.

(a) *Description*. A charitable remainder annuity trust is a trust which complies with the applicable provisions of § 1.664–1 and meets all of the following requirements:

(1) *Required payment of annuity amount*—(i) *Payment of sum certain at least annually*. The governing instrument provides that the trust will pay a sum certain not less often than annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section.

(*a*) *General rule applicable to all trusts.* A trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire annuity amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(*1*) The trust pays the annuity amount by distributing property (other than cash) that it owned at the close of the taxable year to pay the annuity amount, and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the annuity amount is due;

(*2*) The trust pays the annuity amount by distributing cash that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); or

(*3*) The trust pays the annuity amount by distributing cash received as a return of basis in any asset that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), and that is sold by the trust during the year for which the annuity amount is due.

(*b*) *Special rule for trusts created before* December 10, 1998. In addition to the circumstances described in paragraph (a)(1)(i)(*a*) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because the annuity amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the sum certain to be paid each year as the annuity amount is 15 percent or less of the initial net fair market value of the property irrevocably passing in trust as determined for federal tax purposes.

(*c*) *Reasonable time.* For this paragraph (a)(1)(i), a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file

Form 5227, ''Split-Interest Trust Information Return,'' (including extensions) for the taxable year.

(*d*) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(*a*) of this section:

Example. X is a charitable remainder annuity trust described in section 664(d)(1) that was created after December 10, 1998. The prorated annuity amount payable from *X* for Year 1 is $100. The trustee does not pay the annuity amount to the recipient by the close of Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b)(2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the recipient of the annuity a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 annuity amount due for Year 1. The trust owned the asset at the end of Year 1. Under §1.664–1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under §1.664–1(d)(1), the character of the annuity amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(*a*) of this section.

(*e*) *Effective date.* This paragraph (a)(1)(i) is applicable for taxable years ending after April 18, 1997. However, paragraphs (a)(1)(i)(*a*)(*2*) and (*3*) of this section apply only to distributions made on or after January 5, 2001.

(ii) *Definition of sum certain.* A sum certain is a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period. For example, a provision for an amount which is the same every year to A until his death and concurrently an amount which is the same every year to B until his death, with the amount to each recipient to terminate at his death, would satisfy the above rule. Similarly, provisions for an amount to A and B for their joint lives and then to the survivor would satisfy the above rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the stated amount payable after such a distribution: *Provided,* That:

(a) The reduced amount payable is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) *Sum certain stated as a fraction or percentage.* The stated dollar amount may be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes. If the stated dollar amount is so expressed and such market value is incorrectly determined by the fiduciary, the requirement of this subparagraph will be satisfied if the governing instrument provides that in such event the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of §1.664–1. See paragraph (d)(4) of §1.664–1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to future contributions. For rules relating to required adjustments for underpayments or overpayments of the amount described in this paragraph in respect of payments made during a reasonable period of administration, see paragraph (a)(5) of §1.664–1. The application of the rule permitting the stated dollar amount to be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes may be illustrated by the following example:

Example. The will of X provides for the transfer of one-half of his residuary estate to a charitable remainder annuity trust which is required to pay to W for life an annuity equal to 5 percent of the initial net fair market value of the interest passing in trust as finally determined for Federal tax purposes. The annuity is to be paid on December 31 of each year computed from the date of X's death. The will also provides that if such initial net fair market value is incorrectly determined, the trust shall pay to W, in the case of an undervaluation, or be repaid by W, in the case of an overvaluation, an amount equal to the difference between the amount which the trust should have paid if the correct value were used and the amount which the trust actually paid. X dies on March 1, 1971. The executor files an estate tax return showing the value of the residuary estate as $250,000 before reduction for taxes and expenses of $50,000. The executor paid to W $4,192 ([$250,000 − $50,000]×1/2×5 percent×306/365) on December 31, 1971. On January 1, 1972, the executor transfers one-half of the residue of the estate to the trust. The trust adopts the calendar year as its taxable year. The value of the residuary estate is finally determined for Federal tax purposes to be $240,000 ($290,000 − $50,000). Accordingly, the amount which the executor should have paid to W is $5,030 ([$290,000 − $50,000]× 1/2×5 percent×306/365). Consequently, an additional amount of $838 ($5,030 − $4,192) must be paid to W within a reasonable period after the final determination of value for Federal tax purposes.

(iv) *Computation of annuity amount in certain circumstances—(a) Short taxable years.* The governing instrument provides that, in the case of a taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount determined under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

(b) Last taxable year of period. The governing instrument provides that, in the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount which must be distributed under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of which is 365 (366 if February 29 is a day included in the numerator). See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the annuity amount with the regular payment next preceding the termination of the period specified therein.

(2) *Minimum annuity amount*—(i) *General rule.* The total amount payable under subparagraph (1) of this paragraph is not less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes.

(ii) *Reduction of annuity amount in certain cases.* A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the stated amount payable upon the death of a recipient or the expiration of a term of years provided that:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total amounts payable each year under subparagraph (1) of this paragraph after such distribution are not less than a stated dollar amount which bears the same ratio to 5 percent of the initial net fair market value of the trust assets as the net fair market value of the trust assets immediately after such distribution bears to the net fair market value of the trust assets immediately before such distribution.

(iii) *Rule applicable to inter vivos trust which does not provide for payment of minimum annuity amount.* In the case where the grantor of an inter vivos trust underestimates in good faith the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes and specifies a fixed dollar amount for the annuity which is less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes, the trust will be deemed to have met the 5 percent requirement if the grantor or his representative consents, by appropriate agreement with the District Director, to accept an amount equal to 20 times the annuity as the fair market value of the property placed in trust for purposes of determining the appropriate charitable contributions deduction.

(3) *Permissible recipients*—(i) *General rule.* The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of the creation of the trust. A named person or persons may include members of a named class provided that, in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the annuity amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that an amount shall be paid to his children living at his death.

(ii) *Power to alter amount paid to recipients.* A trust is not a charitable remainder annuity trust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the annuity among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) *Other payments.* No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization described in section 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) *Period of payment of annuity amount*—(i) *General rules.* The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be

ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of an annuity amount to A for his life and then to B for a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of an annuity amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) *Relationship to 5 percent requirement.* The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A and B for their joint lives and then to the survivor for his life;

(b) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for a term of years not longer than 20 years and then to B for life (provided B was living at the date of creation of the trust);

(d) An amount to A for his life and concurrently an amount to B for his life (the amount to each recipient to terminate at his death) if the amount given to each individual is not less than 5 percent of the initial net fair market value of the property placed in trust; or

(e) An amount to A for his life and concurrently an equal amount to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c), if the total of the amounts given to A and B is not less than 5 percent of the initial net fair market value of the property placed in trust.

(6) *Permissible remaindermen*—(i) *General rule.* At the end of the period specified in subparagraph (5) of this paragraph the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use.

(ii) *Treatment of trust.* If all of the trust corpus is to be retained for such use, the taxable year of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charitable remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as sections 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) *Concurrent or successive remaindermen.* Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) *Alternative remaindermen.* The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of one or more alternative organizations which are described in section 170(c) at such time or retained for such use. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) *Additional contributions.* A trust is not a charitable remainder annuity trust unless its governing instrument provides that no additional contributions may be made to the charitable remainder annuity trust after the initial contribution. For purposes of this section, all property passing to a charitable remainder annuity trust by reason of death of the grantor shall be considered one contribution.

(c) *Calculation of the fair market value of the remainder interest of a charitable remainder annuity trust.* For purposes of sections 170, 2055, 2106, and 2522, the fair market value of the remainder interest of a charitable remainder annuity trust (as described in this section) is the net fair market value (as of the appropriate valuation date) of the property placed in trust less the present value of the annuity. For purposes of this section, *valuation date* means, in general, the date on which the property is transferred to the trust by the donor regardless of when the trust is created. In the case of transfers to a charitable remainder annuity trust for which the valuation date is after April 30, 1989, if an election is made under section 7520 and §1.7520–2(b) to compute the present value of the charitable interest by use of the interest rate component for either of the 2 months preceding the month in which the transfer is made, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. For purposes of section 2055 or 2106, the valuation date is the date of death unless the alternate valuation date is elected in accordance with section 2032, in which event, and within the limitations set forth in section 2032 and the regulations thereunder, the valuation date is the alternate valuation date. If the decedent's estate elects the alternate valuation date under section 2032 and also elects, under section 7520 and §1.7520–2(b), to use the interest rate component for one of the 2 months preceding the alternate valuation date, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. The present value of an annuity is computed under §20.2031–7(d) of this chapter (Estate Tax Regulations) for transfers for which the valuation date is after April 30, 1999, or under §20.2031–7A (a) through (e) of this chapter, whichever is applicable, for transfers for which the valuation date is before May 1, 1999. See, however, §1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances).

(d) *Deduction for transfers to a charitable remainder annuity trust.* For rules relating to a deduction for transfers to a charitable remainder annuity trust, see section 170, 2055, 2106, or 2522 and the regulations thereunder. Any claim for deduction on any return for the value of a remainder interest in a charitable remainder annuity trust must be supported by a full statement attached to the return showing the computation of the present value of such interest. The deduction allowed by section 170 is limited to the fair market value of the remainder interest of a charitable remainder annuity trust regardless of whether an organization described in section 170(c) also receives a portion of the annuity. For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see section 170(e)(1)(A) or 170(e)(1)(B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

[T.D. 7202, 37 FR 16918, Aug. 23, 1972, as amended by T.D. 7955, 49 FR 19983, May 11, 1984; T.D. 8540, 59 FR 30116, June 10, 1994; T.D. 8791, 63 FR 68191, Dec. 10, 1998; T.D. 8819, 64 FR 23229, Apr. 30, 1999; T.D. 8819, Mar. 9, 2000, 65 FR 12471; T.D. 8926, 66 FR 1037, Jan. 5, 2001]

§ 1.664–3 Charitable remainder unitrust.

(a) *Description*. A charitable remainder unitrust is a trust which complies with the applicable provisions of § 1.664–1 and meets all of the following requirements:

(1) *Required payment of unitrust amount*—(i) *Payment of fixed percentage at least annually*—(*a*) *General rule.* The governing instrument provides that the trust will pay not less often than annually a fixed percentage of the net fair market value of the trust assets determined annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section. This paragraph (a)(1)(i)(*a*) is applicable for taxable years ending after April 18, 1997.

(*b*) *Income exception*. Instead of the amount described in *(a)* of this subdivision (i), the governing instrument may provide that the trust shall pay for any year either the amount described in *(1)* or the total of the amounts described in *(1)* and *(2)* of this subdivision *(b)*.

(*1*) The amount of trust income for a taxable year to the extent that such amount is not more than the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section.

(*2*) An amount of trust income for a taxable year that is in excess of the amount required to be distributed under paragraph (a)(1)(i)(*a*) of this section for such year to the extent that (by reason of paragraph (a)(1)(i)(*b*)(*1*) of this section) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(*3*) For purposes of this paragraph (a)(1)(i)(*b*), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

(*4*) The rules in paragraph (a)(1)(i)(*b*)(*1*) and (*2*) of this section are applicable for taxable years ending after April 18, 1997. The rule in the first sentence of paragraph (a)(1)(i)(*b*)(*3*) is applicable for taxable years ending after April 18, 1997. The rules in the second, fourth, and fifth sentences of paragraph (a)(1)(i)(*b*)(*3*) are applicable for taxable years ending after January 2, 2004. The rule in the third sentence of paragraph (a)(1)(i)(*b*)(*3*) is applicable for sales or exchanges that occur after April 18, 1997. The rule in the sixth sentence of paragraph (a)(1)(i)(*b*)(*3*) is applicable for trusts created after January 2, 2004.

(*c*) *Combination of methods.* Instead of the amount described in paragraph (a)(1)(i)(*a*) or (*b*) of this section, the governing instrument may provide that the trust will pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section for an initial period and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust only if the governing instrument provides that—

(*1*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) of this section to the method prescribed in paragraph (a)(1)(i)(*a*) of this section is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons;

(*2*) The change from the method prescribed in paragraph (a)(1)(i)(*b*) of this section to the method prescribed in paragraph (a)(1)(i)(*a*) of this section occurs at the beginning of the taxable year that immediately follows the taxable year during which the date or event specified under paragraph (a)(1)(i)(*c*)(*1*) of this section occurs; and

(*3*) Following the trust's conversion to the method described in paragraph (a)(1)(i)(*a*) of this section, the trust will pay at least annually to the permissible recipients the amount described only in paragraph (a)(1)(i)(*a*) of this section and not any amount described in paragraph (a)(1)(i)(*b*) of this section.

(*d*) *Triggering event.* For purposes of paragraph (a)(1)(i)(*c*)(*1*) of this section, a triggering event based on the sale of unmarketable assets as defined in §1.664–1(a)(7)(ii), or the marriage, divorce, death, or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other persons.

(*e*) *Examples.* The following examples illustrate the rules in paragraph (a)(1)(i)(*c*) of this section. For each example, assume that the governing instrument of charitable remainder unitrust *Y* provides that *Y* will initially pay not less often than annually the amount described in paragraph (a)(1)(i)(*b*) of this section and then pay the amount described in paragraph (a)(1)(i)(*a*) of this section (calculated using the same fixed percentage) for the remaining years of the trust and that the requirements of paragraphs (a)(1)(i)(*c*)(*2*) and (*3*) of this section are satisfied. The examples are as follows:

Example 1. Y is funded with the donor's former personal residence. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the trust sells the residence. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 2. Y is funded with cash and an unregistered security for which there is no available exemption permitting public sale under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered on the earlier of the date when the stock is sold or at the time the restrictions on its public sale lapse or are otherwise lifted. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 3. Y is funded with cash and with a security that may be publicly traded under the Securities and Exchange Commission rules. The governing instrument of *Y* provides that the change in method for computing the annual unitrust amount is triggered when the stock is sold. *Y* does not provide for a combination of methods that satisfies the requirements of paragraph (a)(1)(i)(*c*) of this section because the sale of the publicly-traded stock is within the discretion of the trustee.

Example 4. S establishes *Y* for her granddaughter, *G*, when *G* is 10 years old. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which *G* turns 18 years old. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 5. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the donor is married. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 6. The governing instrument of *Y* provides that if the donor divorces, the change in method for computing the annual unitrust amount will occur as of the first day of the year following the year of the divorce. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 7. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's first child is born. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 8. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's father dies. *Y* provides for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 9. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary's financial advisor determines that the beneficiary should begin receiving payments under the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

Example 10. The governing instrument of *Y* provides for the change in method for computing the annual unitrust amount as of the first day of the year following the year in which the noncharitable beneficiary submits a request to the trustee that the trust convert to the second prescribed payment method. Because the change in methods for paying the unitrust amount is triggered by an event that is within a person's control, *Y* does not provide for a combination of methods that satisfies paragraph (a)(1)(i)(*c*) of this section.

(*f*) *Effective date*—(*1*) *General rule.* Paragraphs (a)(1)(i)(*c*), (*d*), and (*e*) of this section are applicable for charitable remainder trusts created on or after December 10, 1998.

(*2*) *General rule regarding reformations of combination of method unitrusts.* If a trust is created on or after December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust will qualify as a charitable remainder unitrust only if it is amended or reformed to use the initial method for computing the unitrust amount throughout the term of the trust, or is reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. If a trust was created before December 10, 1998, and contains a provision allowing a change in calculating the unitrust amount that does not comply with the provisions of paragraph (a)(1)(i)(*c*) of this section, the trust may be reformed to use the initial method for computing the unitrust amount throughout the term of the trust without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664–1(a)(4), or may be reformed in accordance with paragraph (a)(1)(i)(*f*)(*3*) of this section. Except as provided in paragraph (a)(1)(i)(*f*)(*3*) of this section, a qualified charitable remainder unitrust will not continue to qualify as a charitable remainder unitrust if it is amended or reformed to add a provision allowing a change in the method for calculating the unitrust amount.

(*3*) *Special rule for reformations of trusts that begin by June 8, 1999.* Notwithstanding paragraph (a)(1)(i)(*f*)(*2*) of this section, if a trust either provides for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section, or provides for payment of the unitrust amount under only the method prescribed in paragraph (a)(1)(i)(*b*) of this section, then the trust may be reformed to allow for a combination of methods permitted under paragraph (a)(1)(i)(*c*) of this section without causing the trust to fail to function exclusively as a charitable remainder unitrust under § 1.664–1(a)(4) or to engage in an act of self-dealing under section 4941 if the trustee begins legal proceedings to reform by June 8, 1999. The triggering event under the reformed governing instrument may not occur in a year prior to the year in which the court issues the order reforming the trust, except for situations in which the governing instrument prior to reformation already provided for payment of the unitrust amount under a combination of methods that is not permitted under paragraph (a)(1)(i)(*c*) of this section and the triggering event occurred prior to the reformation.

(*g*) *Payment under general rule for fixed percentage trusts.* When the unitrust amount is computed under paragraph (a)(1)(i)(*a*) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the entire unitrust amount in the hands of the recipient is characterized only as income from the categories described in section 664(b)(1), (2), or (3), except to the extent it is characterized as corpus described in section 664(b)(4) because—

(*1*) The trust pays the unitrust amount by distributing property (other than cash) that it owned at the close of the taxable year, and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the unitrust amount is due;

(*2*) The trust pays the unitrust amount by distributing cash that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); or

(*3*) The trust pays the unitrust amount by distributing cash received as a return of basis in any asset that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), and that is sold by the trust during the year for which the unitrust amount is due.

(*h*) *Special rule for fixed percentage trusts created before December 10, 1998.* When the unitrust amount is computed under paragraph (a)(1)(i)(*a*) of this section, a trust created before December 10, 1998, will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because the unitrust amount is paid after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year and the fixed percentage to be paid each year as the unitrust amount is 15 percent or less of the net fair market value of the trust assets as determined under paragraph (a)(1)(iv) of this section.

(*i*) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(*g*) of this section:

Example. *X* is a charitable remainder unitrust that calculates the unitrust amount under paragraph (a)(1)(i)(*a*) of this section. *X* was created after December 10, 1998. The prorated unitrust amount payable from *X* for Year 1 is $100. The trustee does not pay the unitrust amount to the recipient by the end of the Year 1. At the end of Year 1, *X* has only $95 in the ordinary income category under section 664(b)(1) and no income in the capital gain or tax-exempt income categories under section 664(b) (2) or (3), respectively. By April 15 of Year 2, in addition to $95 in cash, the trustee distributes to the unitrust recipient a capital asset with a $5 fair market value and a $2 adjusted basis to pay the $100 unitrust amount due for Year 1. The trust owned the asset at the end of Year 1. Under §1.664–1(d)(5), the distribution is treated as a sale by *X*, resulting in *X* recognizing a $3 capital gain. The trustee elects to treat the capital gain as occurring on the last day of Year 1. Under §1.664–1(d)(1), the character of the unitrust amount for Year 1 in the recipient's hands is $95 of ordinary income, $3 of capital gain income, and $2 of trust corpus. For Year 1, *X* satisfied paragraph (a)(1)(i)(*g*) of this section.

(*j*) *Payment under income exception.* When the unitrust amount is computed under paragraph (a)(1)(i)(*b*) of this section, a trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664–1(a)(4)) merely because payment of the unitrust amount is made after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year.

(*k*) *Reasonable time.* For paragraphs (a)(1)(i) (*g*), (*h*), and (*j*) of this section, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, ''Split-Interest Trust Information Return,'' (including extensions) for the taxable year.

(*l*) *Effective date.* Paragraphs (a)(1)(i) (*g*), (*h*), (*i*), (*j*), and (*k*) of this section are applicable for taxable years ending after April 18, 1997. Paragraphs (a)(1)(i)(*g*)(*2*) and (*3*) apply only to distributions made on or after January 5, 2001.

(ii) *Definition of fixed percentage.* The fixed percentage may be expressed either as a fraction or as a percentage and must be payable each year in the period specified in subparagraph (5) of this paragraph. A percentage is fixed if the percentage is the same either as to each recipient or as to the total percentage payable each year of such period. For example, provision for a fixed percentage which is the same every year to A until his death and concurrently a fixed percentage which is the same every year to B until his death, the fixed percentage to each recipient to terminate at his death, would satisfy the rule. Similarly, provision for a fixed percentage to A and B for their joint lives and then to the survivor would satisfy the rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the fixed percentage payable after such distribution *Provided* That:

(a) The reduced fixed percentage is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) *Rules applicable to incorrect valuations.* The governing instrument provides that in the case where the net fair market value of the trust assets is incorrectly determined by the fiduciary, the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of §1.664–1. See paragraph (d)(4) of §1.664–1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to additional contributions.

(iv) *Rules applicable to valuation.* In computing the net fair market value of the trust assets there shall be taken into account all assets and liabilities without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date during the taxable year of the trust, or by taking the average of valuations made on more than one date during the taxable year of the trust, so long as the same valuation date or dates and valuation methods are used each year. If the governing instrument does not specify the valuation date or dates, the trustee must select such date or dates and indicate the selection on the first return on Form 5227, ''Split-Interest Trust Information Return,'' that the trust must file. The amount described in subdivision (i)*(a)* of this subparagraph which must be paid each year must be based upon the valuation for such year.

(v) *Computation of unitrust amount in certain circumstances—(a) Short taxable years.* The governing instrument provides that, in the case of a taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(1) The amount determined under subdivision (i)*(a)* of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator),

(2) The amount determined under subdivision (i)*(b)* of this subparagraph shall be computed by using the amount determined under subdivision *(a)(1)* of this subdivision (v), and

(3) If no valuation date occurs before the end of the taxable year of the trust, the trust assets shall be valued as of the last day of the taxable year of the trust.

(b) Last taxable year of period. (1) The governing instrument provides that, in

the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(i) The unitrust amount which must be distributed under subdivision (i)*(a)* of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of which is 365 (366 if February 29 is a day included in the numerator),

(ii) The amount determined under subdivision (i)(*b*) of this subparagraph shall be computed by using the amount determined under *(b)(1)(i)* of this subdivision (v), and

(iii) If no valuation date occurs before the end of such period, the trust assets shall be valued as of the last day of such period.

(2) See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the unitrust amount with the regular payment next preceding the termination of the period specified therein.

(2) *Minimum unitrust amount*—(i) *General rule.* The fixed percentage described in subparagraph (1)(i) of this paragraph with respect to all beneficiaries taken together is not less than 5 percent.

(ii) *Reduction of unitrust amount in certain cases.* A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the fixed percentage payable upon the death of a recipient or the expiration of a term of years *Provided* That:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total of the percentage payable under subparagraph (1) of this paragraph after such distribution is not less than 5 percent.

(3) *Permissible recipients*—(i) *General rule.* The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of creation of the trust. A named person or persons may include members of a named class except in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the unitrust amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that the required amount shall be paid to his children living at his death.

(ii) *Power to alter amount paid to recipients.* A trust is not a charitable remainder unitrust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if subpart E, part 1, subchapter J, chapter 1, subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the fixed percentage among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) *Other payments.* No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization described in section 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any

recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that, in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) *Period of payment of unitrust amount*—(i) *General rules.* The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of a unitrust amount to A for his life and then to B for a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of a unitrust amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) *Relationship to 5 percent requirement.* The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) A fixed percentage of at least 5 percent to A and B for their joint lives and then to the survivor for his life;

(b) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years and then to B for life (provided B was living at the creation of the trust);

(d) A fixed percentage to A for his life and concurrently a fixed percentage to B for his life (the percentage to each recipient to terminate at his death) if the percentage given to each individual is not less than 5 percent;

(e) A fixed percentage to A for his life and concurrently an equal percentage to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c) if the total of the percentages is not less than 5 percent for the entire period described in this subparagraph.

(6) *Permissible remaindermen*—(i) *General rule.* At the end of the period specified in subparagraph (5) of this paragraph, the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in

section 170(c) or retained, in whole or in part, for such use.

(ii) *Treatment of trust.* If all of the trust corpus is to be retained for such use, the taxable year of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charitable remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as section 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) *Concurrent or successive remaindermen.* Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) *Alternative remaindermen.* The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of or retained for the use of one or more alternative organizations which are described in section 170(c) at such time. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) *Additional contributions.* A trust is not a charitable remainder annuity trust unless its governing instrument either prohibits additional contributions to the trust after the initial contribution or provides that for the taxable year of the trust in which the additional contribution is made:

(1) Where no valuation date occurs after the time of the contribution and during the taxable year in which the contribution is made, the additional property shall be valued as of the time of contribution; and

(2) The amount described in paragraph (a)(1)(i)*(a)* of this section shall be computed by multiplying the fixed percentage by the sum of (i) the net fair market value of the trust assets (excluding the value of the additional property and any earned income from and any appreciation on such property after its contribution), and (ii) that proportion of the value of the additional property (that was excluded under subdivision (i) of this paragraph), which the number of days in the period which begins with the date of contribution and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section bears to the number of days in the period which begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section.

For purposes of this section, all property passing to a charitable remainder unitrust by reason of death of the grantor shall be considered one contribution. The application of the preceding rules may be illustrated by the following examples:

Example 1. On March 2, 1971, X makes an additional contribution of property to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is January 1 of each year. For purposes of computing the required payout with respect to the additional contribution for the year of contribution, the additional contribution is valued on March 2, 1971, the time of contribution. The property had a value on that date of $5,000. Income from such property in the amount of $250 was received on December 31, 1971. The required payout with respect to the additional contribution for the year of contribution is $208 (5 percent×$5,000×305/365). The income earned after the date of the contribution and after the regular valuation date does not enter into the computation.

Example 2. On July 1, 1971, X makes an additional contribution of $10,000 to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is December 31 of each year. The fixed percentage is 5 percent. Between July 1, 1971, and December 31, 1971, the additional property appreciates in value to $12,500 and earns $500 of income. Because the regular valuation date for the year of contribution occurs after the date of the additional contribution, the additional contribution including income earned by it is valued on the regular valuation date. Thus, the required payout with respect to the additional contribution is $325.87 (5 percent×[$12,500+$500]×183/365).

(c) *Calculation of the fair market value of the remainder interest of a charitable remainder unitrust.* See §1.664–4 for rules relating to the calculation of the fair market value of the remainder interest of a charitable remainder unitrust.

(d) *Deduction for transfers to a charitable remainder unitrust.* For rules relating to a deduction for transfers to a charitable remainder unitrust, see section 170, 2055, 2106, or 2522 and the regulations thereunder. The deduction allowed by section 170 for transfers to charity is limited to the fair market value of the remainder interest of a charitable remainder unitrusts regardless of whether an organization described in section 170(c) also receives a portion of the amount described in §1.664–3(a)(1). For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see section 170(e)(1) (A) or (B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

[T.D. 7202, 37 FR 16920, Aug. 23, 1972, as amended by T.D. 8791, 63 FR 68192, Dec. 10, 1998; T.D. 8926, 66 FR 1038, Jan. 5, 2001; T.D. 9102, 69 FR 20, Jan. 2, 2004]

§ 1.664–4 Calculation of the fair market value of the remainder interest in a charitable remainder unitrust.

(a) *Rules for determining present value.* For purposes of sections 170, 2055, 2106, and 2522, the fair market value of a remainder interest in a charitable remainder unitrust (as described in §1.664–3) is its present value determined under paragraph (d) of this section. The present value determined under this section shall be computed on the basis of—

(1) Life contingencies determined as to each life involved, from the values of *lx* set forth in Table 90CM contained in §20.2031–7(d)(7) of this chapter in the case of transfers for which the valuation date is after April 30, 1999; or from Table 80CNSMT contained §20.2031–7A(e)(4) of this chapter in the case of transfer for which the valuation date is after April 30, 1989, and before May 1, 1999. See §20.2031–7A(a) through (d) of this chapter, whichever is applicable, for transfers for which the valuation date is before May 1, 1989;

(2) Interest at the section 7520 rate in the case of transfers for which the valuation date is after April 30, 1989, or 10 percent in the case of transfers to charitable remainder unitrusts made after November 30, 1983, for which the valuation date is before May 1, 1989. See §20.2031–7A (a) through (c) of this chapter, whichever is applicable, for transfers for which the valuation date is before December 1, 1983; and

(3) The assumption that the amount described in §1.664–3(a)(1)(*i*)(*a*) is distributed in accordance with the payout sequence described in the governing instrument. If the governing instrument does not prescribe when the distribution is made during the period for which the payment is made, for purposes of this section, the distribution is considered payable on the first day of the period for which the payment is made.

(b) *Actuarial Computations by the Internal Revenue Service.* The regulations in this and in related sections provide tables of actuarial factors and examples that illustrate the use of the tables in determining the value of remainder interests in property. Section 1.7520–1(c)(2) refers to government publications that provide additional tables of factors and examples of computations for more complex situations. If the computation requires the use of a factor that is not provided in this section, the Commissioner may supply the factor upon a request for a ruling. A request for a ruling must be accompanied by a recitation of the facts including the date of birth of each measuring life, and copies of the relevant documents. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (See § 601.601(d)(2)(ii)(*b*) of this chapter) and include payment of the required user fee. If the Commissioner furnishes the factor, a copy of the letter supplying the factor should be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in this section.

(c) *Statement supporting deduction required.* Any claim for a deduction on any return for the value of a remainder interest in a charitable remainder unitrust must be supported by a full statement attached to the return showing the computation of the present value of such interest.

(d) *Valuation.* The fair market value of a remainder interest in a charitable remainder unitrust (as described in § 1.664–3) for transfers for which the valuation date is after April 30, 1999, is its present value determined under paragraph (e) of this section. The fair market value of a remainder interest in a charitable remainder unitrust (as described in § 1.664–3) for transfers for which the valuation date is before May 1, 1999, is its present value determined under the following sections:

Valuation dates		Applicable Regulations
After	Before	
	01–01–52	1.664–4A(a)
12–31–51	01–01–71	1.664–4A(b)
12–31–70	12–01–83	1.664–4A(c)
11–30–83	05–01–89	1.664–4A(d)
04–30–89	05–01–99	1.664–4A(e)

(e) *Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after April 30, 1999*—(1) *In general.* Except as otherwise provided in paragraph (e)(2) of this section, in the case of transfers for which the valuation date is after April 30, 1999, the present value of a remainder interest is determined under paragraphs (e)(3) through (e)(7) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under § 1.664-3(a)(1)(v) if the taxable year of the trust were to end on such date. See, however, § 1.7520–3(b) (relating to exceptions to the use of the prescribed tables under certain circumstances).

(2) *Transitional rules for valuation of charitable remainder unitrusts.* (i) For purposes of sections 2055, 2106, or 2624, if on May 1, 1999, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after April 30, 1999, without having regained competency to dispose of the decedent's property, or the decedent died within 90 days of the date that the decedent first regained competency after April 30, 1999, the present value of a remainder interest under this section is determined as if the valuation date with respect to the decedent's gross estate is either before May 1, 1999, or after April 30, 1999, at the option of the decedent's executor.

(ii) For purposes of sections 170, 2055, 2106, 2522, or 2624, in the case of transfers to a charitable remainder unitrust for which the valuation date is after April 30, 1999, and before July 1, 1999, the present value of a remainder interest based on one or more measuring lives is determined under this section by use of the section 7520 interest rate for the month in which the valuation date occurs (see §§ 1.7520–1(b) and 1.7520–2(a)(2)) and the appropriate actuarial tables under either paragraph (e)(7) of this section or § 1.664–4A(e)(6), at the option of the donor or the decedent's executor, as the case may be.

(iii) For purposes of paragraphs (e)(2)(i) and (ii) of this section, where the donor or decedent's executor is given the option to use the appropriate actuarial tables under either paragraph (e)(7) of this section or § 1.664–4A(e)(6), the donor or decedent's executor must use the same actuarial table with respect to each individual transaction and with respect to all transfers occurring on the valuation date (for example, gift and income tax charitable deductions with respect to the same transfer must be determined based on the same tables, and all assets includible in the gross estate and/or estate tax deductions claimed must be valued based on the same tables).

(3) *Adjusted payout rate.* For transfers for which the valuation date is after April 30, 1989, the adjusted payout rate is determined by using the appropriate Table F in paragraph (e)(6) of this section, for the section 7520 interest rate applicable to the transfer. If the interest rate is between 4.2 and 14 percent, see paragraph (e)(6) of this section. If the interest rate is below 4.2 percent or greater than 14 percent, see paragraph (b) of this section. The adjusted payout rate is determined by multiplying the fixed percentage described in §1.664–3(a)(1)(i)(*a*) by the factor describing the payout sequence of the trust and the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution or distributions shall be made during the taxable year of the trust, see paragraph (a) of this section. In the case of a trust having a payout sequence for which no figures have been provided by the appropriate table, and in the case of a trust that determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see paragraph (b) of this section.

(4) *Period is a term of years.* If the period described in §1.664–3(a)(5) is a term of years, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after November 30, 1983, is the factor under the appropriate adjusted payout rate in Table D of paragraph (e)(6) of this section corresponding to the number of years in the term. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph. For purposes of this section, the valuation date is, in the case of an inter vivos transfer, the date on which the property is transferred to the trust by the donor. However, if an election is made under section 7520 and §1.7520–2(b) to compute the present value of the charitable interest by use of the interest rate component for either of the 2 months preceding the month in which the date of transfer falls, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. In the case of a testamentary transfer under section 2055, 2106, or 2624, the valuation date is the date of death, unless the alternate valuation date is elected under section 2032, in which event, and within the limitations set forth in section 2032 and the regulations thereunder, the valuation date is the alternate valuation date. If the decedent's estate elects the alternate valuation date under section 2032 and also elects, under section 7520 and §1.7520–2(b), to use the interest rate component for one of the 2 months preceding the alternate valuation date, the month so elected is the valuation date for purposes of determining the interest rate and mortality tables. The application of this paragraph (e)(4) may be illustrated by the following example:

Example. D transfers $100,000 to a charitable remainder unitrust on January 1. The trust instrument requires that the trust pay 8 percent of the fair market value of the trust assets as of January 1st for a term of 12 years to D in quarterly payments (March 31, June 30, September 30, and December 31). The section 7520 rate for January (the month that the transfer occurred) is 9.6 percent. Under Table F(9.6) in paragraph(e)(6) of this section, the appropriate adjustment factor is .944628 for quarterly payments payable at the end of each quarter. The adjusted payout rate is 7.557 (8%× .944628). Based on the remainder factors in Table D in paragraph(e)(6) of this section, the present value of the remainder interest is $38,950.30, computed as follows:

Factor at 7.4 percent for 12 years ...	.397495
Factor at 7.6 percent for 12 years ...	.387314

Difference	.010181

Interpolation adjustment:

$$\frac{7.557\% - 7.4\%}{0.2\%} = \frac{x}{.010181}$$

$$x = .007992$$

Factor at 7.4 percent for 12 years	.397495
Less: Interpolation adjustment	.007992
Interpolated factor	.389503

Present value of remainder interest:

($100,000×.389503)..........$38,950.30

(5) *Period is the life of one individual.* If the period described in §1.664–3(a)(5) is the life of one individual, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1999, is the factor in Table U(1) in paragraph (e)(7) of this section under the appropriate adjusted payout. For purposes of the computations described in this paragraph, the age of an individual is the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in the appropriate table, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the valuation date as determined in paragraph (e)(4) of this section) of the property placed in trust by the factor determined under this paragraph (e)(5). If the adjusted payout rate is between 4.2 and 14 percent, see paragraph (e)(7) of this section. If the adjusted payout rate is below 4.2 percent or greater than 14 percent, see paragraph (b) of this section. The application of this paragraph (e)(5) may be illustrated by the following example:

Example. A, who is 44 years and 11 months old, transfers $100,000 to a charitable remainder unitrust on January 1st. The trust instrument requires that the trust pay to A semiannually (on June 30 and December 31) 9 percent of the fair market value of the trust assets as of January 1st during A's life. The section 7520 rate for January is 9.6 percent. Under Table F(9.6) in paragraph (e)(6) of this section, the appropriate adjustment factor is .933805 for semiannual payments payable at the end of the semiannual period. The adjusted payout rate is 8.404 (9% X .933805). Based on the remainder factors in Table U(1) in paragraph (e)(7) of this section, the present value of the remainder interest is $10,109.00, computed as follows:

Factor at 8.4 percent at age 45	.10117
Factor at 8.6 percent at age 45	.09715
Difference	.00402

Interpolation adjustment:

$$\frac{8.404\% - 8.4\%}{0.2\%} = \frac{x}{.00402}$$

$$x = .00008$$

Factor at 8.4 percent at age 45	.10117
Less: Interpolation adjustment	.00008
Interpolated Factor	.10109

Present value of remainder interest:

($100,000×.10109)..........$10,109.00

(6) *Actuarial Table D and F (4.2 through 14.0) for transfers for which the valuation date is after April 30, 1989.* For transfers for which the valuation date is after April 30, 1989, the present value of a charitable remainder unitrust interest that is dependent upon a term of years is determined by using the section 7520 rate and the tables in this paragraph (e)(6). For transfers for which the valuation date is after April 30, 1999, where the present value of a charitable remainder unitrust interest is dependent on the termination of a life interest, see paragraph (e)(5) of this section. See, however, §1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Many actuarial factors not contained in the following tables are contained in Internal Revenue Service Publication 1458, ''Actuarial Values, Book Beth,'' (1999). A copy of this publication is available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

TABLE D—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
1	.958000	.956000	.954000	.952000	.950000	.948000	.946000	.944000	.942000	.940000
2	.917764	.913936	.910116	.906304	.902500	.898704	.894916	.891136	.887364	.883600
3	.879218	.873723	.868251	.862801	.857375	.851971	.846591	.841232	.835897	.830584
4	.842291	.835279	.828311	.821387	.814506	.807669	.800875	.794123	.787415	.780749
5	.806915	.798527	.790209	.781960	.773781	.765670	.757627	.749652	.741745	.733904
6	.773024	.763392	.753859	.744426	.735092	.725855	.716716	.707672	.698724	.689870
7	.740557	.729802	.719182	.708694	.698337	.688111	.678013	.668042	.658198	.648478
8	.709454	.697691	.686099	.674677	.663420	.652329	.641400	.630632	.620022	.609569
9	.679657	.666993	.654539	.642292	.630249	.618408	.606765	.595317	.584061	.572995
10	.651111	.637645	.624430	.611462	.598737	.586251	.573999	.561979	.550185	.538615
11	.623764	.609589	.595706	.582112	.568800	.555766	.543003	.530508	.518275	.506298
12	.597566	.582767	.568304	.554170	.540360	.526866	.513681	.500800	.488215	.475920
13	.572469	.557125	.542162	.527570	.513342	.499469	.485942	.472755	.459898	.447365
14	.548425	.532611	.517222	.502247	.487675	.473496	.459701	.446281	.433224	.420523
15	.525391	.509177	.493430	.478139	.463291	.448875	.434878	.421289	.408097	.395292
16	.503325	.486773	.470732	.455188	.440127	.425533	.411394	.397697	.384427	.371574
17	.482185	.465355	.449079	.433339	.418120	.403405	.389179	.375426	.362131	.349280
18	.461933	.444879	.428421	.412539	.397214	.382428	.368163	.354402	.341127	.328323
19	.442532	.425304	.408714	.392737	.377354	.362542	.348282	.334555	.321342	.308624
20	.423946	.406591	.389913	.373886	.358486	.343690	.329475	.315820	.302704	.290106

TABLE D—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
1	.938000	.936000	.934000	.932000	.930000	.928000	.926000	.924000	.922000	.920000
2	.879844	.876096	.872356	.868624	.864900	.861184	.857476	.853776	.850084	.846400
3	.825294	.820026	.814781	.809558	.804357	.799179	.794023	.788889	.783777	.778688
4	.774125	.767544	.761005	.754508	.748052	.741638	.735265	.728933	.722643	.716393
5	.726130	.718421	.710779	.703201	.695688	.688240	.680855	.673535	.666277	.659082
6	.681110	.672442	.663867	.655383	.646990	.638687	.630472	.622346	.614307	.606355
7	.638881	.629406	.620052	.610817	.601701	.592701	.583817	.575048	.566391	.557847
8	.599270	.589124	.579129	.569282	.559582	.550027	.540615	.531344	.522213	.513219
9	.562115	.551420	.540906	.530571	.520411	.510425	.500609	.490962	.481480	.472161
10	.527264	.516129	.505206	.494492	.483982	.473674	.463564	.453649	.443925	.434388
11	.494574	.483097	.471863	.460866	.450104	.439570	.429260	.419171	.409298	.399637
12	.463910	.452179	.440720	.429527	.418596	.407921	.397495	.387314	.377373	.367666
13	.435148	.423239	.411632	.400320	.389295	.378550	.368081	.357879	.347938	.338253
14	.408169	.396152	.384465	.373098	.362044	.351295	.340843	.330680	.320799	.311193
15	.382862	.370798	.359090	.347727	.336701	.326002	.315620	.305548	.295777	.286297
16	.359125	.347067	.335390	.324082	.313132	.302529	.292264	.282326	.272706	.263394
17	.336859	.324855	.313254	.302044	.291213	.280747	.270637	.260870	.251435	.242322
18	.315974	.304064	.292579	.281505	.270828	.260533	.250610	.241044	.231823	.222936
19	.296383	.284604	.273269	.262363	.251870	.241775	.232065	.222724	.213741	.205101
20	.278008	.266389	.255233	.244522	.234239	.224367	.214892	.205797	.197069	.188693

TABLE D—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
1	.918000	.916000	.914000	.912000	.910000	.908000	.906000	.904000	.902000	.900000
2	.842724	.839056	.835396	.831744	.828100	.824464	.820836	.817216	.813604	.810000
3	.773621	.768575	.763552	.758551	.753571	.748613	.743677	.738763	.733871	.729000
4	.710184	.704015	.697886	.691798	.685750	.679741	.673772	.667842	.661951	.656100
5	.651949	.644878	.637868	.630920	.624032	.617205	.610437	.603729	.597080	.590490
6	.598489	.590708	.583012	.575399	.567869	.560422	.553056	.545771	.538566	.531441
7	.549413	.541089	.532873	.524764	.516761	.508863	.501069	.493377	.485787	.478297
8	.504361	.495637	.487046	.478585	.470253	.462048	.453968	.446013	.438180	.430467

TABLE D—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST—Continued

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
9	.463003	.454004	.445160	.436469	.427930	.419539	.411295	.403196	.395238	.387420
10	.425037	.415867	.406876	.398060	.389416	.380942	.372634	.364489	.356505	.348678
11	.390184	.380934	.371885	.363031	.354369	.345895	.337606	.329498	.321567	.313811
12	.358189	.348936	.339902	.331084	.322475	.314073	.305871	.297866	.290054	.282430
13	.328817	.319625	.310671	.301949	.293453	.285178	.277119	.269271	.261628	.254187
14	.301854	.292777	.283953	.275377	.267042	.258942	.251070	.243421	.235989	.228768
15	.277102	.268184	.259533	.251144	.243008	.235119	.227469	.220053	.212862	.205891
16	.254380	.245656	.237213	.229043	.221137	.213488	.206087	.198928	.192001	.185302
17	.233521	.225021	.216813	.208887	.201235	.193847	.186715	.179830	.173185	.166772
18	.214372	.206119	.198167	.190505	.183124	.176013	.169164	.162567	.156213	.150095
19	.196794	.188805	.181125	.173741	.166643	.159820	.153262	.146960	.140904	.135085
20	.180657	.172946	.165548	.158452	.151645	.145117	.138856	.132852	.127096	.121577

TABLE D—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
1	.898000	.896000	.894000	.892000	.890000	.888000	.886000	.884000	.882000	.880000
2	.806404	.802816	.799236	.795664	.792100	.788544	.784996	.781456	.777924	.774400
3	.724151	.719323	.714517	.709732	.704969	.700227	.695506	.690807	.686129	.681472
4	.650287	.644514	.638778	.633081	.627422	.621802	.616219	.610673	.605166	.599695
5	.583958	.577484	.571068	.564708	.558406	.552160	.545970	.539835	.533756	.527732
6	.524394	.517426	.510535	.503720	.496981	.490318	.483729	.477214	.470773	.464404
7	.470906	.463613	.456418	.449318	.442313	.435402	.428584	.421858	.415222	.408676
8	.422874	.415398	.408038	.400792	.393659	.386637	.379726	.372922	.366226	.359635
9	.379741	.372196	.364786	.357506	.350356	.343334	.336437	.329663	.323011	.316478
10	.341007	.333488	.326118	.318896	.311817	.304881	.298083	.291422	.284896	.278501
11	.306224	.298805	.291550	.284455	.277517	.270734	.264102	.257617	.251278	.245081
12	.274989	.267729	.260645	.253734	.246990	.240412	.233994	.227734	.221627	.215671
13	.246941	.239886	.233017	.226331	.219821	.213486	.207319	.201317	.195475	.189791
14	.221753	.214937	.208317	.201887	.195641	.189575	.183684	.177964	.172409	.167016
15	.199134	.192584	.186236	.180083	.174121	.168343	.162744	.157320	.152065	.146974
16	.178822	.172555	.166495	.160634	.154967	.149488	.144191	.139071	.134121	.129337
17	.160582	.154609	.148846	.143286	.137921	.132746	.127754	.122939	.118295	.113817
18	.144203	.138530	.133069	.127811	.122750	.117878	.113190	.108678	.104336	.100159
19	.129494	.124123	.118963	.114007	.109247	.104676	.100286	.096071	.092024	.088140
20	.116286	.111214	.106353	.101694	.097230	.092952	.088853	.084927	.081166	.077563

TABLE D—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
1	.878000	.876000	.874000	.872000	.870000	.868000	.866000	.864000	.862000	.860000
2	.770884	.767376	.763876	.760384	.756900	.753424	.749956	.746496	.743044	.739600
3	.676836	.672221	.667628	.663055	.658503	.653972	.649462	.644973	.640504	.636056
4	.594262	.588866	.583507	.578184	.572898	.567648	.562434	.557256	.552114	.547008
5	.521762	.515847	.509985	.504176	.498421	.492718	.487068	.481469	.475923	.470427
6	.458107	.451882	.445727	.439642	.433626	.427679	.421801	.415990	.410245	.404567
7	.402218	.395848	.389565	.383368	.377255	.371226	.365279	.359415	.353631	.347928
8	.353147	.346763	.340480	.334297	.328212	.322224	.316332	.310535	.304830	.299218
9	.310063	.303764	.297579	.291507	.285544	.279690	.273944	.268302	.262764	.257327
10	.272236	.266098	.260084	.254194	.248423	.242771	.237235	.231813	.226502	.221302
11	.239023	.233102	.227314	.221657	.216128	.210725	.205446	.200286	.195245	.190319
12	.209862	.204197	.198672	.193285	.188032	.182910	.177916	.173047	.168301	.163675
13	.184259	.178877	.173640	.168544	.163588	.158766	.154075	.149513	.145076	.140760
14	.161779	.156696	.151761	.146971	.142321	.137809	.133429	.129179	.125055	.121054
15	.142042	.137266	.132639	.128158	.123819	.119618	.115550	.111611	.107798	.104106
16	.124713	.120245	.115927	.111754	.107723	.103828	.100066	.096432	.092922	.089531

TABLE D—SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM CERTAIN IN A CHARITABLE REMAINDER UNITRUST—Continued

[Applicable after April 30, 1989]

Years	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
17	.109498	.105334	.101320	.097450	.093719	.090123	.086657	.083317	.080098	.076997
18	.096139	.092273	.088554	.084976	.081535	.078227	.075045	.071986	.069045	.066217
19	.084410	.080831	.077396	.074099	.070936	.067901	.064989	.062196	.059517	.056947
20	.074112	.070808	.067644	.064614	.061714	.058938	.056280	.053737	.051303	.048974

TABLE F(4.2)—WITH INTEREST AT 4.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.989820	.984755	.981389
1	2	.996577	.986432	.981385	.978030
2	3	.993166	.983056	.978026	
3	4	.989767	.979691	.974679	
4	5	.986380	.976338		
5	6	.983004	.972996		
6	7	.979639	.969666		
7	8	.976286			
8	9	.972945			
9	10	.969615			
10	11	.966296			
11	12	.962989			
12	....	.959693			

TABLE F(4.4)—WITH INTEREST AT 4.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.989350	.984054	.980533
1	2	.996418	.985806	.980529	.977021
2	3	.992849	.982275	.977017	
3	4	.989293	.978757	.973517	
4	5	.985749	.975251		
5	6	.982219	.971758		
6	7	.978700	.968277		
7	8	.975195			
8	9	.971702			
9	10	.968221			
10	11	.964753			
11	12	.961298			
12	....	.957854			

TABLE F(4.6)—WITH INTEREST AT 4.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.988882	.983354	.979680
1	2	.996259	.985183	.979676	.976015
2	3	.992532	.981498	.976011	
3	4	.988820	.977826	.972360	
4	5	.985121	.974168		
5	6	.981436	.970524		
6	7	.977764	.966894		
7	8	.974107			
8	9	.970463			
9	10	.966832			
10	11	.963216			
11	12	.959613			
12	....	.956023			

TABLE F(4.8)—WITH INTEREST AT 4.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.988415	.982657	.978830
1	2	.996101	.984561	.978825	.975013
2	3	.992217	.980722	.975008	
3	4	.988348	.976898	.971206	
4	5	.984494	.973089		
5	6	.980655	.969294		
6	7	.976831	.965515		
7	8	.973022			
8	9	.969228			
9	10	.965448			
10	11	.961684			
11	12	.957934			
12	....	.954198			

TABLE F(5.0)—WITH INTEREST AT 5.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.987950	.981961	.977982
1	2	.995942	.983941	.977977	.974014
2	3	.991901	.979949	.974009	
3	4	.987877	.975973	.970057	
4	5	.983868	.972013		
5	6	.979876	.968069		
6	7	.975900	.964141		
7	8	.971940			
8	9	.967997			
9	10	.964069			
10	11	.960157			
11	12	.956261			
12	....	.952381			

TABLE F(5.2)—WITH INTEREST AT 5.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.987486	.981268	.977137
1	2	.995784	.983323	.977132	.973018
2	3	.991587	.979178	.973012	
3	4	.987407	.975050	.968911	
4	5	.983244	.970940		
5	6	.979099	.966847		
6	7	.974972	.962771		
7	8	.970862			
8	9	.966769			
9	10	.962694			
10	11	.958636			
11	12	.954594			
12	....	.950570			

TABLE F(5.4)—WITH INTEREST AT 5.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.987023	.980577	.976295
1	2	.995627	.982707	.976289	.972026
2	3	.991273	.978409	.972019	
3	4	.986938	.974131	.967769	
4	5	.982622	.969871		
5	6	.978325	.965629		
6	7	.974047	.961407		
7	8	.969787			
8	9	.965546			
9	10	.961323			
10	11	.957119			
11	12	.952934			
12	....	.948767			

TABLE F(5.6)—WITH INTEREST AT 5.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.986562	.979888	.975455
1	2	.995470	.982092	.975449	.971036
2	3	.990960	.977643	.971029	
3	4	.986470	.973214	.966630	
4	5	.982001	.968805		
5	6	.977552	.964416		
6	7	.973124	.960047		
7	8	.968715			
8	9	.964326			
9	10	.959958			
10	11	.955609			
11	12	.951279			
12	....	.946970			

TABLE F(5.8)—WITH INTEREST AT 5.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.986102	.979201	.974618
1	2	.995313	.981480	.974611	.970050
2	3	.990647	.976879	.970043	
3	4	.986004	.972300	.965496	
4	5	.981382	.967743		
5	6	.976782	.963206		
6	7	.972203	.958692		
7	8	.967646			
8	9	.963111			
9	10	.958596			
10	11	.954103			
11	12	.949631			
12	....	.945180			

TABLE F(6.0)—WITH INTEREST AT 6.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.985643	.978516	.973784
1	2	.995156	.980869	.973776	.969067
2	3	.990336	.976117	.969059	
3	4	.985538	.971389	.964365	
4	5	.980764	.966684		
5	6	.976014	.962001		
6	7	.971286	.957341		
7	8	.966581			
8	9	.961899			
9	10	.957239			
10	11	.952603			
11	12	.947988			
12	....	.943396			

TABLE F(6.2)—WITH INTEREST AT 6.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.985185	.977833	.972952
1	2	.995000	.980259	.972944	.968087
2	3	.990024	.975358	.968079	
3	4	.985074	.970481	.963238	
4	5	.980148	.965628		
5	6	.975247	.960799		
6	7	.970371	.955995		
7	8	.965519			
8	9	.960691			
9	10	.955887			
10	11	.951107			
11	12	.946352			
12	....	.941620			

TABLE F(6.4)—WITH INTEREST AT 6.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.984729	.977152	.972122
1	2	.994844	.979652	.972114	.967110
2	3	.989714	.974600	.967101	
3	4	.984611	.969575	.962115	
4	5	.979534	.964576		
5	6	.974483	.959602		
6	7	.969458	.954654		
7	8	.964460			
8	9	.959487			
9	10	.954539			
10	11	.949617			
11	12	.944721			
12	....	.939850			

TABLE F(6.6)—WITH INTEREST AT 6.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.984274	.976473	.971295
1	2	.994688	.979046	.971286	.966136
2	3	.989404	.973845	.966127	
3	4	.984149	.968672	.960995	
4	5	.978921	.963527		
5	6	.973721	.958408		
6	7	.968549	.953317		
7	8	.963404			
8	9	.958286			
9	10	.953196			
10	11	.948132			
11	12	.943096			
12	....	.938086			

TABLE F(6.8)—WITH INTEREST AT 6.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.983821	.975796	.970471
1	2	.994533	.978442	.970461	.965165
2	3	.989095	.973092	.965156	
3	4	.983688	.967772	.959879	
4	5	.978309	.962481		
5	6	.972961	.957219		
6	7	.967641	.951985		
7	8	.962351			
8	9	.957089			
9	10	.951857			
10	11	.946653			
11	12	.941477			
12	....	.936330			

TABLE F(7.0)—WITH INTEREST AT 7.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.983368	.975122	.969649
1	2	.994378	.977839	.969639	.964198
2	3	.988787	.972342	.964187	
3	4	.983228	.966875	.958766	
4	5	.977700	.961439		
5	6	.972203	.956033		
6	7	.966736	.950658		
7	8	.961301			
8	9	.955896			
9	10	.950522			
10	11	.945178			
11	12	.939864			
12	....	.934579			

TABLE F(7.2)—WITH INTEREST AT 7.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.982917	.974449	.968830
1	2	.994223	.977239	.968819	.963233
2	3	.988479	.971593	.963222	
3	4	.982769	.965980	.957658	
4	5	.977091	.960400		
5	6	.971446	.954851		
6	7	.965834	.949335		
7	8	.960255			
8	9	.954707			
9	10	.949192			
10	11	.943708			
11	12	.938256			
12	....	.932836			

TABLE F(7.4)—WITH INTEREST AT 7.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.982467	.973778	.968013
1	2	.994068	.976640	.968002	.962271
2	3	.988172	.970847	.962260	
3	4	.982311	.965088	.956552	
4	5	.976484	.959364		
5	6	.970692	.953673		
6	7	.964935	.948017		
7	8	.959211			
8	9	.953521			
9	10	.947866			
10	11	.942243			
11	12	.936654			

TABLE F(7.4)—WITH INTEREST AT 7.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS—Continued

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
12	....	.931099			

TABLE F(7.6)—WITH INTEREST AT 7.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.982019	.973109	.967199
1	2	.993914	.976042	.967187	.961313
2	3	.987866	.970103	.961301	
3	4	.981854	.964199	.955451	
4	5	.975879	.958331		
5	6	.969940	.952499		
6	7	.964037	.946703		
7	8	.958171			
8	9	.952340			
9	10	.946544			
10	11	.940784			
11	12	.935058			
12	....	.929368			

TABLE F(7.8)—WITH INTEREST AT 7.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.0000000	.981571	.972442	.966387
1	2	.993761	.975447	.966374	.960357
2	3	.987560	.969361	.960345	
3	4	.981398	.963312	.954353	
4	5	.975275	.957302		
5	6	.969190	.951329		
6	7	.963143	.945393		
7	8	.957133			
8	9	.951161			
9	10	.945227			
10	11	.939329			
11	12	.933468			
12	....	.927644			

TABLE F(8.0)—WITH INTEREST AT 8.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.981125	.971777	.965578
1	2	.993607	.974853	.965564	.959405
2	3	.987255	.968621	.959392	
3	4	980944	.962429	.953258	
4	5	.974673	.956276		
5	6	.968442	.950162		
6	7	.962250	.944088		
7	8	.956099			
8	9	.949987			
9	10	.943913			
10	11	.937879			
11	12	.931883			
12	....	.925926			

TABLE F(8.2)—WITH INTEREST AT 8.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.980680	.971114	.964771
1	2	.993454	.974261	.964757	.958455
2	3	.986951	.967883	.958441	
3	4	.980490	.961547	.952167	
4	5	.974072	.955253		
5	6	.967695	.949000		
6	7	.961361	.942788		
7	8	.955068			
8	9	.948816			
9	10	.942605			
10	11	.936434			
11	12	.930304			
12	....	.924214			

TABLE F(8.2)—WITH INTEREST AT 8.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.980237	.970453	.963966
1	2	.993301	.973670	.963952	.957509
2	3	.986647	.967148	.957494	
3	4	.980037	.960669	.951080	
4	5	.973472	.954233		
5	6	.966951	.947841		
6	7	.960473	.941491		
7	8	.954039			
8	9	.947648			
9	10	.941300			
10	11	.934994			
11	12	.928731			
12	....	.922509			

TABLE F(8.6)—WITH INTEREST AT 8.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.979794	.969794	.963164
1	2	.993148	.973081	.963149	.956565
2	3	.986344	.966414	.956550	
3	4	.979586	.959793	.949996	
4	5	.972874	.953217		
5	6	.966209	.946686		
6	7	.959589	.940199		
7	8	.953014			
8	9	.946484			
9	10	.940000			
10	11	.933559			
11	12	.927163			
12	....	.920810			

TABLE F(8.8)—WITH INTEREST AT 8.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.979353	.969136	.962364
1	2	.992996	.972494	.962349	.955624
2	3	.986041	.965683	.955609	
3	4	.979135	.958919	.948916	
4	5	.972278	.952203		
5	6	.965468	.945534		
6	7	.958706	.938912		
7	8	.951992			
8	9	.945324			
9	10	.938703			
10	11	.932129			
11	12	.925600			
12	....	.919118			

TABLE F(9.0)—WITH INTEREST AT 9.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.978913	.968481	.961567
1	2	.992844	.971908	.961551	.954686
2	3	.985740	.964954	.954670	
3	4	.978686	.958049	.947839	
4	5	.971683	.951193		
5	6	.964730	.944387		
6	7	.957826	.937629		
7	8	.950972			
8	9	.944167			
9	10	.937411			
10	11	.930703			
11	12	.924043			
12	....	.917431			

TABLE F(9.2)—WITH INTEREST AT 9.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.978474	.967827	.960772
1	2	.992693	.971324	.960755	.953752
2	3	.985439	.964226	.953734	
3	4	.978238	.957180	.946765	
4	5	.971089	.950186		
5	6	.963993	.943242		
6	7	.956949	.936350		
7	8	.949956			
8	9	.943014			
9	10	.936123			
10	11	.929283			
11	12	.922492			
12	....	.915751			

TABLE F(9.4)—WITH INTEREST AT 9.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.978037	.967176	.959980
1	2	.992541	.970742	.959962	.952820
2	3	.985138	.963501	.952802	
3	4	.977790	.956315	.945695	
4	5	.970497	.949182		
5	6	.963258	.942102		
6	7	.956074	.935075		
7	8	.948942			
8	9	.941865			
9	10	.934839			
10	11	.927867			
11	12	.920946			
12	....	.914077			

TABLE F(9.6)—WITH INTEREST AT 9.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.977600	.966526	.959190
1	2	.992390	.970161	.959171	.951890
2	3	.984838	.962778	.951872	
3	4	.977344	.955452	.944628	
4	5	.969906	.948181		
5	6	.962526	.940965		
6	7	.955201	.933805		
7	8	.947932			
8	9	.940718			
9	10	.933560			
10	11	.926455			
11	12	.919405			
12	....	.912409			

TABLE F(9.8)—WITH INTEREST AT 9.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.977165	.965878	.958402
1	2	.992239	.969582	.958382	.950964
2	3	.984539	.962057	.950945	
3	4	.976898	.954591	.943565	
4	5	.969317	.947183		
5	6	.961795	.939832		
6	7	.954331	.932539		
7	8	.946924			
8	9	.939576			
9	10	.932284			
10	11	.925049			
11	12	.917870			
12	....	.910747			

TABLE F(10.0)—WITH INTEREST AT 10.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.976731	.965232	.957616
1	2	.992089	.969004	.957596	.950041
2	3	.984240	.961338	.950021	
3	4	.976454	.953733	.942505	
4	5	.968729	.946188		
5	6	.961066	.938703		
6	7	.953463	.931277		
7	8	.945920			
8	9	.938436			
9	10	.931012			
10	11	.923647			
11	12	.916340			
12	....	.909091			

TABLE F(10.2)—WITH INTEREST AT 10.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.976298	.964588	.956833
1	2	.991939	.968428	.956812	.949120
2	3	.983943	.960622	.949099	
3	4	.976011	.952878	.941448	
4	5	.968143	.945196		
5	6	.960338	.937577		
6	7	.952597	.930019		
7	8	.944918			
8	9	.937301			
9	10	.929745			
10	11	.922250			
11	12	.914816			
12	....	.907441			

TABLE F(10.4)—WITH INTEREST AT 10.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.975867	.963946	.956052
1	2	.991789	.967854	.956031	.948202
2	3	.983645	.959907	.948181	
3	4	.975568	.952025	.940395	
4	5	.967558	.944208		
5	6	.959613	.936455		
6	7	.951734	.928765		
7	8	.943919			
8	9	.936168			
9	10	.928481			
10	11	.920858			
11	12	.913296			
12	....	.905797			

TABLE F(10.6)—WITH INTEREST AT 10.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.975436	.963305	.955274
1	2	.991639	.967281	.955252	.947287
2	3	.983349	.959194	.947265	
3	4	.975127	.951174	.939345	
4	5	.966974	.943222		
5	6	.958890	.935336		
6	7	.950873	.927516		
7	8	.942923			
8	9	.935039			
9	10	.927222			
10	11	.919470			
11	12	.911782			
12	....	.904159			

TABLE F(10.8)—WITH INTEREST AT 10.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.975007	.962667	.954498
1	2	.991490	.966710	.954475	.946375
2	3	.983052	.958483	.946352	
3	4	.974687	.950327	.938299	
4	5	.966392	.942239		
5	6	.958168	.934221		
6	7	.950014	.926271		
7	8	.941930			
8	9	.933914			
9	10	.925966			
10	11	.918086			
11	12	.910273			
12	....	.902527			

TABLE F(11.0)—WITH INTEREST AT 11.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.974579	.962030	.953724
1	2	.991341	.966140	.953700	.945466
2	3	.982757	.957774	.945442	
3	4	.974247	.949481	.937255	
4	5	.965811	.941260		
5	6	.957449	.933109		
6	7	.949158	.925029		
7	8	.940939			
8	9	.932792			
9	10	.924715			
10	11	.916708			
11	12	.908770			
12	....	.900901			

TABLE F(11.2)—WITH INTEREST AT 11.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.974152	.961395	.952952
1	2	.991192	.965572	.952927	.944559
2	3	.982462	.957068	.944534	
3	4	.973809	.948638	.936215	
4	5	.965232	.940283		
5	6	.956731	.932001		
6	7	.948304	.923792		
7	8	.939952			
8	9	.931673			
9	10	.923467			
10	11	.915333			
11	12	.907272			
12	....	.899281			

TABLE F(11.4)—WITH INTEREST AT 11.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.973726	.960762	.952183
1	2	.991044	.965005	.952157	.943655
2	3	.982168	.956363	.943630	
3	4	.973372	.947798	.935178	
4	5	.964654	.939309		
5	6	.956015	.930896		
6	7	.947452	.922559		
7	8	.938967			
8	9	.930557			
9	10	.922223			
10	11	.913964			
11	12	.905778			
12	....	.897666			

TABLE F(11.6)—WITH INTEREST AT 11.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.973302	.960130	.951416
1	2	.990896	.964440	.951389	.942754
2	3	.981874	.955660	.942728	
3	4	.972935	.946959	.934145	
4	5	.964077	.938338		
5	6	.955300	.929795		
6	7	.946603	.921330		
7	8	.937985			
8	9	.929445			
9	10	.920984			
10	11	.912599			
11	12	.904290			
12	....	.896057			

TABLE F(11.8)—WITH INTEREST AT 11.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Seminannual period	Quarterly period	Monthly period
	1	1.000000	.972878	.959501	.950651
1	2	.990748	.963877	.950624	.941855
2	3	.981582	.954959	.941828	
3	4	.972500	.946124	.933114	
4	5	.963502	.937370		
5	6	.954588	.928698		
6	7	.945756	.920105		
7	8	.937006			
8	9	.928337			
9	10	.919748			
10	11	.911238			
11	12	.902807			
12	....	.894454			

TABLE F(12.0)—WITH INTEREST AT 12.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Seminannual period	Quarterly period	Monthly period
	1	1.000000	.972456	.958873	.949888
1	2	.990600	.963315	.949860	.940960
2	3	.981289	.954260	.940932	
3	4	.972065	.945290	.932087	
4	5	.962928	.936405		
5	6	.953877	.927603		
6	7	.944911	.918884		
7	8	.936029			
8	9	.927231			
9	10	.918515			
10	11	.909882			
11	12	.901329			
12	....	.892857			

TABLE F(12.2)—WITH INTEREST AT 12.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.972034	.958247	.949128
1	2	.990453	.962754	.949099	.940067
2	3	.980997	.953563	.940038	
3	4	.971632	.944460	.931063	
4	5	.962356	.935443		
5	6	.953168	.926512		
6	7	.944069	.917667		
7	8	.935056			
8	9	.926129			
9	10	.917287			
10	11	.908530			
11	12	.899856			
12	....	.891266			

TABLE F(12.4)—WITH INTEREST AT 12.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Montly period
	1	1.000000	.971614	.957623	.948370
1	2	.990306	.962195	.948340	.939176
2	3	.980706	.952868	.939147	
3	4	.971199	.943631	.930043	
4	5	.961785	.934484		
5	6	.952461	.925425		
6	7	.943228	.916454		
7	8	.934085			
8	9	.925030			
9	10	.916063			
10	11	.907183			
11	12	.898389			
12	....	.889680			

TABLE F(12.6)—WITH INTEREST AT 12.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	but less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.971195	.957000	.947614
1	2	.990159	.961638	.947583	.938289
2	3	.980416	.952175	.938258	
3	4	.970768	.942805	.929025	
4	5	.961215	.933527		
5	6	.951756	.924341		
6	7	.942390	.915245		
7	8	.933117			
8	9	.923934			
9	10	.914842			
10	11	.905840			
11	12	.896926			

TABLE F(12.6)—WITH INTEREST AT 12.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS—Continued

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	but less than	Annual period	Semiannual period	Quarterly period	Monthly period
12	....	.888099			

TABLE F(12.8)—WITH INTEREST AT 12.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	but less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.970777	.956379	.946860
1	2	.990013	.961082	.946828	.937403
2	3	.980126	.951484	.937372	
3	4	.970337	.941981	.928011	
4	5	.960647	.932574		
5	6	.951053	.923260		
6	7	.941554	.914040		
7	8	.932151			
8	9	.922842			
9	10	.913625			
10	11	.904501			
11	12	.895468			
12	....	.886525			

TABLE F(13.0)—WITH INTEREST AT 13.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.970360	.955760	.946108
1	2	.989867	.960528	.946075	.936521
2	3	.979836	.950795	.936489	
3	4	.969908	.941160	.926999	
4	5	.960079	.931623		
5	6	.950351	.922183		
6	7	.940721	.912838		
7	8	.931188			
8	9	.921753			
9	10	.912412			
10	11	.903167			
11	12	.894015			
12	....	.884956			

TABLE F(13.2)—WITH INTEREST AT 13.2 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.969945	.955143	.945359
1	2	.989721	.959975	.945325	.935641
2	3	.979548	.950107	.935608	
3	4	.969479	.940341	.925991	
4	5	.959514	.930675		
5	6	.949651	.921109		
6	7	.939889	.911641		
7	8	.930228			
8	9	.920667			
9	10	.911203			
10	11	.901837			
11	12	.892567			
12	....	.883392			

TABLE F(13.4)—WITH INTEREST AT 13.4 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 umber of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quaterly period	Monthly period
	1	1.000000	.969530	.954527	.944611
1	2	.989575	.959423	.944577	.934764
2	3	.979260	.949422	.934730	
3	4	.969051	.939524	.924986	
4	5	.958949	.929730		
5	6	.948953	.920038		
6	7	.939060	.910447		
7	8	.929271			
8	9	.919584			
9	10	.909998			
10	11	.900511			
11	12	.891124			
12	....	.881834			

TABLE F(13.6)—WITH INTEREST AT 13.6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 umber of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quaterly period	Monthly period
	1	1.000000	.969117	.953913	.943866
1	2	.989430	.958873	.943831	.933890
2	3	.978972	.948738	.933854	
3	4	.968624	.938710	.923984	
4	5	.958386	.928788		
5	6	.948256	.918971		
6	7	.938233	.909257		
7	8	.928316			
8	9	.918504			
9	10	.908796			
10	11	.899190			
11	12	.889686			
12	....	.880282			

TABLE F(13.8)—WITH INTEREST AT 13.8 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first full taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.968704	.953301	.943123
1	2	.989285	.958325	.943087	.933018
2	3	.978685	.948056	.932982	
3	4	.968199	.937898	.922985	
4	5	.957824	.927849		
5	6	.947561	.917907		
6	7	.937408	.908072		
7	8	.927364			
8	9	.917428			
9	10	.907598			
10	11	.897873			
11	12	.888252			
12	....	.878735			

TABLE F(14.0)—WITH INTEREST AT 14.0 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS

[Applicable after April 30, 1989]

1 Number of months by which the valuation date for the first rull taxable year of the trust precedes the first payout		2 Factors for payout at the end of each period			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1	1.000000	.968293	.952691	.942382
1	2	.989140	.957778	.942345	.932148
2	3	.978399	.947377	.932111	
3	4	.967774	.937088	.921989	
4	5	.957264	.926912		
5	6	.946868	.916846		
6	7	.936586	.906889		
7	8	.926415			
8	9	.916354			
9	10	.906403			
10	11	.896560			
11	12	.886824			
12	....	.877193			

(7) *Actuarial Table U(1) for transfers for which the valuation date is after April 30, 1999.* For transfers for which the valuation date is after April 30, 1999, the present value of a charitable remainder unitrust interest that is dependent on the termination of a life interest is determined by using the section 7520 rate, Table U(1) in this paragraph (e)(7), and Table F(4.2) through (14.0) in paragraph (e)(6) of this section. See, however, §1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Many actuarial factors not contained in the following tables are contained in Internal Revenue Service Publication 1458, ''Actuarial Values, Book Beth,'' (7–1999). A copy of this publication is available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

TABLE U(1)—BASED ON LIFE TABLE 90CM UNITRUST SINGLE LIFE REMAINDER FACTORS APPLICABLE FOR TRANSFERS AFTER APRIL 30, 1999

[Adjusted payout rate]

Age	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	.8%	6.0%
0	.06177	.05580	.05061	.04609	.04215	.03871	.03570	.03307	.03075	.02872
1	.05543	.04925	.04388	.03919	.03509	.03151	.02838	.02563	.02321	.02109
2	.05716	.05081	.04528	.04045	.03622	.03252	.02927	.02642	.02391	.02170
3	.05920	.05268	.04699	.04201	.03765	.03382	.03046	.02750	.02490	.02260
4	.06143	.05475	.04889	.04376	.03926	.03530	.03182	.02876	.02605	.02366
5	.06384	.05697	.05095	.04567	.04103	.03694	.03334	.03016	.02735	.02487
6	.06637	.05933	.05315	.04771	.04292	.03870	.03497	.03168	.02876	.02618
7	.06905	.06183	.05547	.04987	.04494	.04058	.03673	.03332	.03029	.02761
8	.07186	.06445	.05792	.05216	.04708	.04258	.03859	.03506	.03192	.02914
9	.07482	.06722	.06052	.05460	.04936	.04471	.04060	.03694	.03369	.03079
10	.07793	.07015	.06327	.05718	.05179	.04700	.04274	.03896	.03559	.03259
11	.08120	.07323	.06617	.05991	.05435	.04942	.04502	.04111	.03762	.03450
12	.08461	.07645	.06920	.06277	.05706	.05197	.04744	.04339	.03978	.03655
13	.08812	.07976	.07234	.06574	.05985	.05461	.04993	.04576	.04202	.03867
14	.09168	.08313	.07552	.06874	.06269	.05729	.05247	.04815	.04428	.04081
15	.09527	.08652	.07872	.07176	.06554	.05999	.05501	.05055	.04655	.04296
16	.09886	.08991	.08192	.07478	.06839	.06267	.05754	.05294	.04880	.04508
17	.10249	.09334	.08515	.07782	.07126	.06537	.06008	.05533	.05105	.04720
18	.10616	.09680	.08842	.08090	.07415	.06809	.06264	.05774	.05332	.04933
19	.10994	.10037	.09178	.08407	.07714	.07091	.06529	.06023	.05566	.05153
20	.11384	.10406	.09527	.08737	.08025	.07383	.06805	.06283	.05811	.05384
21	.11790	.10790	.09891	.09080	.08349	.07690	.07094	.06555	.06068	.05626
22	.12208	.11188	.10267	.09436	.08686	.08008	.07395	.06839	.06336	.05879
23	.12643	.11601	.10659	.09808	.09038	.08342	.07710	.07138	.06618	.06146
24	.13095	.12031	.11069	.10197	.09408	.08692	.08042	.07452	.06915	.06427
25	.13567	.12481	.11497	.10605	.09795	.09060	.08392	.07784	.07230	.06726
26	.14058	.12950	.11945	.11032	.10202	.09447	.08760	.08134	.07563	.07042
27	.14571	.13442	.12415	.11481	.10631	.09856	.09149	.08505	.07916	.07379
28	.15104	.13953	.12904	.11949	.11078	.10284	.09558	.08895	.08288	.07733
29	.15656	.14484	.13414	.12438	.11546	.10731	.09986	.09304	.08679	.08106
30	.16229	.15034	.13943	.12946	.12034	.11198	.10433	.09732	.09089	.08498
31	.16821	.15605	.14493	.13474	.12541	.11685	.10900	.10179	.09517	.08909
32	.17433	.16196	.15063	.14023	.13069	.12193	.11387	.10647	.09966	.09339
33	.18068	.16810	.15655	.14595	.13620	.12723	.11897	.11137	.10437	.09791
34	.18724	.17446	.16270	.15189	.14193	.13275	.12430	.11650	.10930	.10265
35	.19405	.18107	.16910	.15808	.14791	.13853	.12987	.12187	.11448	.10764
36	.20109	.18791	.17574	.16451	.15414	.14456	.13569	.12749	.11990	.11287
37	.20838	.19500	.18263	.17120	.16062	.15083	.14177	.13337	.12558	.11835
38	.21593	.20236	.18979	.17816	.16739	.15739	.14813	.13953	.13154	.12412
39	.22374	.20998	.19723	.18540	.17443	.16423	.15477	.14597	.13779	.13017
40	.23183	.21789	.20496	.19294	.18177	.17138	.16172	.15272	.14434	.13653
41	.24021	.22611	.21299	.20079	.18943	.17885	.16899	.15980	.15123	.14322
42	.24889	.23463	.22134	.20896	.19741	.18665	.17660	.16721	.15845	.15025
43	.25786	.24344	.23000	.21744	.20572	.19477	.18453	.17496	.16601	.15762
44	.26712	.25257	.23896	.22625	.21435	.20322	.19281	.18305	.17391	.16534
45	.27665	.26196	.24821	.23534	.22328	.21198	.20139	.19145	.18213	.17338
46	.28644	.27163	.25774	.24472	.23251	.22105	.21028	.20018	.19068	.18174
47	.29647	.28155	.26754	.25438	.24201	.23040	.21947	.20919	.19952	.19041
48	.30676	.29173	.27760	.26431	.25181	.24004	.22896	.21852	.20868	.19941
49	.31729	.30217	.28794	.27453	.26190	.24999	.23876	.22817	.21817	.20873
50	.32808	.31289	.29856	.28505	.27229	.26026	.24889	.23814	.22799	.21839
51	.33912	.32387	.30946	.29585	.28299	.27083	.25933	.24845	.23815	.22840
52	.35038	.33507	.32060	.30691	.29395	.28168	.27005	.25904	.24861	.23872
53	.36185	.34651	.33198	.31821	.30517	.29280	.28106	.26993	.25937	.24934
54	.37352	.35815	.34358	.32976	.31664	.30418	.29234	.28110	.27042	.26026
55	.38539	.37002	.35542	.34155	.32836	.31583	.30390	.29256	.28177	.27149
56	.39746	.38209	.36748	.35358	.34034	.32774	.31574	.30431	.29342	.28303
57	.40971	.39437	.37976	.36584	.35257	.33992	.32785	.31634	.30536	.29488
58	.42212	.40682	.39222	.37829	.36500	.35231	.34019	.32862	.31756	.30699
59	.43464	.41939	.40482	.39090	.37759	.36488	.35272	.34109	.32996	.31932
60	.44726	.43207	.41754	.40364	.39034	.37761	.36542	.35375	.34257	.33186
61	.45999	.44488	.43041	.41655	.40326	.39053	.37833	.36662	.35540	.34463
62	.47286	.45785	.44345	.42964	.41639	.40367	.39146	.37974	.36848	.35767
63	.48589	.47098	.45667	.44293	.42972	.41703	.40484	.39311	.38184	.37100
64	.49903	.48426	.47005	.45638	.44324	.43060	.41843	.40671	.39544	.38458
65	.51229	.49766	.48357	.47001	.45694	.44435	.43223	.42054	.40927	.39841
66	.52568	.51121	.49726	.48381	.47084	.45833	.44626	.43461	.42337	.41252
67	.53924	.52495	.51115	.49784	.48498	.47256	.46056	.44898	.43778	.42696
68	.55293	.53883	.52521	.51205	.49932	.48701	.47511	.46360	.45246	.44169
69	.56671	.55283	.53940	.52640	.51382	.50165	.48985	.47844	.46738	.45666
70	.58052	.56687	.55365	.54084	.52843	.51639	.50473	.49342	.48245	.47181
71	.59431	.58091	.56791	.55529	.54306	.53118	.51966	.50847	.49761	.48707
72	.60804	.59490	.58213	.56973	.55768	.54598	.53461	.52357	.51283	.50239
73	.62168	.60881	.59629	.58411	.57227	.56076	.54955	.53866	.52806	.51774

Age	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	.8%	6.0%
74	.63528	.62268	.61042	.59848	.58686	.57555	.56453	.55380	.54335	.53316
75	.64887	.63657	.62458	.61290	.60151	.59041	.57959	.56904	.55875	.54872
76	.66249	.65049	.63880	.62739	.61625	.60538	.59478	.58443	.57432	.56446
77	.67612	.66446	.65307	.64194	.63108	.62046	.61009	.59995	.59005	.58037
78	.68975	.67843	.66736	.65654	.64596	.63561	.62548	.61558	.60590	.59643
79	.70330	.69233	.68160	.67109	.66081	.65074	.64088	.63123	.62178	.61253
80	.71666	.70605	.69566	.68548	.67550	.66573	.65615	.64676	.63755	.62853
81	.72975	.71950	.70946	.69961	.68995	.68047	.67117	.66205	.65310	.64433
82	.74250	.73263	.72293	.71342	.70407	.69490	.68589	.67705	.66837	.65984
83	.75493	.74542	.73608	.72690	.71788	.70902	.70031	.69175	.68333	.67506
84	.76712	.75798	.74900	.74016	.73147	.72292	.71451	.70624	.69810	.69010
85	.77913	.77037	.76175	.75326	.74491	.73668	.72859	.72061	.71276	.70503
86	.79086	.78248	.77423	.76610	.75808	.75019	.74241	.73474	.72719	.71974
87	.80218	.79418	.78628	.77850	.77083	.76326	.75580	.74844	.74118	.73402
88	.81307	.80544	.79790	.79047	.78313	.77589	.76874	.76169	.75473	.74786
89	.82355	.81628	.80909	.80200	.79500	.78808	.78125	.77450	.76783	.76125
90	.83360	.82668	.81985	.81309	.80642	.79982	.79330	.78685	.78048	.77418
91	.84308	.83650	.83000	.82357	.81721	.81092	.80470	.79855	.79246	.78645
92	.85182	.84556	.83937	.83325	.82718	.82119	.81525	.80937	.80356	.79780
93	.85985	.85390	.84800	.84215	.83637	.83064	.82497	.81936	.81379	.80829
94	.86732	.86164	.85601	.85044	.84491	.83944	.83402	.82865	.82333	.81806
95	.87437	.86895	.86359	.85827	.85300	.84778	.84260	.83746	.83237	.82733
96	.88097	.87582	.87070	.86563	.86060	.85561	.85066	.84575	.84088	.83605
97	.88708	.88216	.87727	.87243	.86762	.86285	.85811	.85341	.84875	.84413
98	.89280	.88810	.88343	.87880	.87420	.86964	.86511	.86061	.85614	.85171
99	.89836	.89388	.88943	.88501	.88062	.87626	.87193	.86763	.86336	.85911
100	.90375	.89948	.89525	.89103	.88685	.88269	.87856	.87445	.87037	.86632
101	.90905	.90500	.90097	.89696	.89298	.88902	.88509	.88118	.87729	.87342
102	.91424	.91040	.90658	.90278	.89900	.89524	.89150	.88778	.88408	.88040
103	.91939	.91575	.91214	.90854	.90496	.90139	.89785	.89432	.89081	.88732
104	.92485	.92144	.91805	.91467	.91131	.90796	.90463	.90131	.89800	.89471
105	.93020	.92701	.92383	.92067	.91751	.91437	.91125	.90813	.90502	.90193
106	.93701	.93411	.93122	.92834	.92546	.92260	.91974	.91689	.91405	.91122
107	.94522	.94268	.94013	.93760	.93507	.93254	.93002	.92750	.92499	.92249
108	.95782	.95583	.95385	.95187	.94989	.94791	.94593	.94396	.94199	.94002
109	.97900	.97800	.97700	.97600	.97500	.97400	.97300	.97200	.97100	.97000

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
0	.02693	.02534	.02395	.02271	.02161	.02063	.01976	.01898	.01828	.01765
1	.01922	.01756	.01610	.01480	.01365	.01263	.01171	.01090	.01017	.00951
2	.01975	.01802	.01650	.01514	.01393	.01286	.01190	.01104	.01028	.00959
3	.02056	.01876	.01717	.01575	.01449	.01336	.01235	.01145	.01064	.00992
4	.02155	.01967	.01800	.01652	.01520	.01401	.01296	.01201	.01116	.01039
5	.02266	.02071	.01896	.01741	.01603	.01479	.01368	.01269	.01179	.01098
6	.02389	.02184	.02003	.01841	.01696	.01566	.01450	.01345	.01251	.01166
7	.02522	.02309	.02120	.01950	.01799	.01663	.01540	.01431	.01332	.01242
8	.02665	.02444	.02246	.02069	.01910	.01768	.01640	.01524	.01420	.01326
9	.02821	.02590	.02384	.02199	.02033	.01884	.01750	.01629	.01520	.01421
10	.02990	.02750	.02535	.02342	.02169	.02013	.01872	.01745	.01631	.01526
11	.03172	.02922	.02698	.02497	.02316	.02153	.02006	.01872	.01752	.01643
12	.03365	.03106	.02872	.02663	.02474	.02303	.02149	.02010	.01884	.01769
13	.03566	.03297	.03054	.02835	.02638	.02460	.02299	.02154	.02021	.01901
14	.03770	.03490	.03237	.03010	.02804	.02619	.02450	.02298	.02159	.02033
15	.03973	.03682	.03419	.03182	.02968	.02775	.02599	.02439	.02294	.02162
16	.04173	.03871	.03598	.03352	.03129	.02926	.02743	.02576	.02424	.02286
17	.04372	.04059	.03775	.03519	.03287	.03076	.02884	.02710	.02551	.02406
18	.04573	.04248	.03953	.03686	.03444	.03224	.03024	.02842	.02676	.02524
19	.04780	.04443	.04137	.03859	.03607	.03378	.03169	.02978	.02804	.02646
20	.04997	.04647	.04329	.04040	.03778	.03539	.03321	.03122	.02940	.02773
21	.05226	.04862	.04532	.04232	.03958	.03709	.03481	.03274	.03083	.02909
22	.05465	.05088	.04745	.04432	.04148	.03888	.03650	.03433	.03234	.03052
23	.05716	.05325	.04969	.04645	.04348	.04077	.03830	.03603	.03394	.03203
24	.05983	.05578	.05208	.04871	.04562	.04280	.04021	.03784	.03566	.03367
25	.06266	.05846	.05463	.05112	.04791	.04497	.04227	.03980	.03752	.03543
26	.06566	.06131	.05734	.05369	.05035	.04729	.04448	.04189	.03951	.03732
27	.06887	.06436	.06024	.05646	.05298	.04979	.04686	.04416	.04168	.03939
28	.07225	.06758	.06331	.05938	.05577	.05245	.04940	.04658	.04398	.04159
29	.07581	.07099	.06656	.06248	.05873	.05528	.05210	.04916	.04645	.04394
30	.07956	.07457	.06998	.06575	.06186	.05827	.05495	.05189	.04906	.04644
31	.08348	.07833	.07358	.06920	.06515	.06142	.05797	.05478	.05182	.04908
32	.08761	.08228	.07736	.07282	.06863	.06475	.06116	.05783	.05475	.05189
33	.09195	.08645	.08136	.07666	.07231	.06828	.06454	.06108	.05786	.05488
34	.09651	.09082	.08557	.08070	.07619	.07200	.06812	.06452	.06117	.05805

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
35	.10131	.09545	.09002	.08498	.08030	.07596	.07193	.06818	.06469	.06144
36	.10635	.10031	.09470	.08949	.08465	.08015	.07596	.07206	.06842	.06503
37	.11165	.10542	.09963	.09424	.08923	.08457	.08022	.07617	.07238	.06885
38	.11722	.11081	.10484	.09927	.09409	.08926	.08475	.08054	.07661	.07293
39	.12308	.11648	.11032	.10458	.09922	.09422	.08955	.08518	.08109	.07726
40	.12925	.12246	.11612	.11020	.10466	.09949	.09465	.09011	.08587	.08189
41	.13575	.12877	.12225	.11614	.11043	.10508	.10007	.09537	.09097	.08683
42	.14259	.13542	.12871	.12243	.11654	.11101	.10583	.10097	.09640	.09210
43	.14977	.14242	.13552	.12905	.12298	.11729	.11193	.10690	.10217	.09771
44	.15731	.14976	.14269	.13604	.12979	.12391	.11838	.11318	.10828	.10367
45	.16516	.15743	.15017	.14334	.13691	.13086	.12516	.11979	.11472	.10994
46	.17334	.16544	.15800	.15099	.14438	.13816	.13228	.12674	.12150	.11656
47	.18184	.17375	.16613	.15895	.15217	.14576	.13972	.13400	.12860	.12349
48	.19066	.18240	.17461	.16724	.16029	.15371	.14749	.14161	.13604	.13077
49	.19981	.19138	.18342	.17588	.16875	.16201	.15562	.14956	.14383	.13839
50	.20931	.20072	.19259	.18489	.17759	.17067	.16412	.15790	.15199	.14639
51	.21917	.21042	.20212	.19426	.18679	.17971	.17299	.16660	.16054	.15477
52	.22933	.22043	.21198	.20395	.19633	.18909	.18220	.17566	.16943	.16350
53	.23981	.23076	.22216	.21399	.20621	.19881	.19176	.18506	.17867	.17258
54	.25060	.24141	.23267	.22434	.21642	.20886	.20166	.19480	.18826	.18201
55	.26171	.25239	.24351	.23504	.22697	.21927	.21192	.20491	.19821	.19182
56	.27313	.26369	.25468	.24608	.23787	.23003	.22254	.21538	.20854	.20199
57	.28487	.27531	.26618	.25746	.24912	.24114	.23351	.22621	.21923	.21254
58	.29688	.28722	.27798	.26914	.26067	.25257	.24481	.23738	.23025	.22343
59	.30913	.29937	.29002	.28107	.27249	.26427	.25639	.24882	.24157	.23461
60	.32159	.31175	.30231	.29325	.28457	.27623	.26823	.26055	.25317	.24608
61	.33429	.32437	.31485	.30571	.29692	.28848	.28037	.27257	.26507	.25786
62	.34728	.33730	.32770	.31847	.30960	.30106	.29285	.28495	.27734	.27001
63	.36057	.35053	.34087	.33157	.32262	.31400	.30569	.29769	.28998	.28255
64	.37412	.36404	.35433	.34498	.33596	.32726	.31887	.31078	.30298	.29545
65	.38794	.37783	.36809	.35868	.34961	.34085	.33239	.32422	.31633	.30871
66	.40205	.39193	.38216	.37272	.36361	.35479	.34628	.33804	.33008	.32238
67	.41650	.40639	.39661	.38715	.37800	.36915	.36059	.35230	.34428	.33651
68	.43126	.42117	.41139	.40193	.39277	.38390	.37530	.36697	.35890	.35108
69	.44628	.43622	.42648	.41703	.40787	.39898	.39037	.38201	.37391	.36604
70	.46150	.45149	.44178	.43236	.42321	.41433	.40571	.39735	.38922	.38132
71	.47683	.46689	.45723	.44785	.43873	.42987	.42126	.41290	.40476	.39685
72	.49225	.48238	.47279	.46346	.45439	.44556	.43697	.42862	.42048	.41257
73	.50770	.49793	.48841	.47915	.47013	.46135	.45280	.44447	.43635	.42844
74	.52324	.51358	.50416	.49498	.48603	.47731	.46880	.46051	.45242	.44454
75	.53894	.52939	.52008	.51100	.50214	.49349	.48505	.47681	.46877	.46092
76	.55483	.54543	.53624	.52728	.51852	.50996	.50160	.49344	.48546	.47766
77	.57091	.56167	.55263	.54380	.53516	.52671	.51845	.51038	.50247	.49475
78	.58716	.57809	.56922	.56053	.55203	.54372	.53557	.52760	.51980	.51216
79	.60346	.59459	.58590	.57738	.56904	.56086	.55286	.54501	.53732	.52978
80	.61969	.61102	.60252	.59419	.58601	.57800	.57014	.56243	.55487	.54745
81	.63571	.62726	.61897	.61082	.60283	.59499	.58729	.57974	.57232	.56503
82	.65146	.64324	.63515	.62722	.61942	.61176	.60423	.59683	.58957	.58242
83	.66693	.65893	.65108	.64335	.63575	.62828	.62093	.61371	.60660	.59962
84	.68222	.67447	.66684	.65934	.65195	.64468	.63753	.63049	.62356	.61674
85	.69742	.68993	.68255	.67528	.66812	.66106	.65411	.64727	.64053	.63389
86	.71241	.70517	.69805	.69102	.68410	.67727	.67054	.66390	.65736	.65091
87	.72696	.72000	.71313	.70635	.69967	.69307	.68656	.68014	.67381	.66756
88	.74108	.73438	.72777	.72125	.71480	.70845	.70217	.69597	.68985	.68380
89	.75475	.74832	.74198	.73571	.72951	.72339	.71734	.71137	.70547	.69963
90	.76796	.76180	.75572	.74971	.74376	.73788	.73207	.72633	.72065	.71503
91	.78049	.77460	.76878	.76302	.75732	.75168	.74610	.74058	.73512	.72972
92	.79211	.78647	.78089	.77537	.76990	.76449	.75913	.75383	.74858	.74338
93	.80283	.79743	.79208	.78679	.78154	.77634	.77119	.76610	.76105	.75604
94	.81283	.80765	.80253	.79744	.79240	.78741	.78247	.77756	.77270	.76789
95	.82233	.81737	.81245	.80757	.80274	.79795	.79320	.78849	.78382	.77918
96	.83126	.82651	.82180	.81712	.81248	.80788	.80332	.79880	.79431	.78985
97	.83953	.83498	.83046	.82597	.82152	.81710	.81271	.80836	.80404	.79976
98	.84731	.84294	.83860	.83429	.83002	.82577	.82155	.81737	.81321	.80908
99	.85490	.85071	.84656	.84243	.83832	.83425	.83020	.82618	.82219	.81822
100	.86229	.85828	.85431	.85035	.84642	.84252	.83864	.83478	.83095	.82714
101	.86958	.86575	.86195	.85818	.85442	.85069	.84698	.84329	.83962	.83597
102	.87674	.87310	.86947	.86587	.86229	.85873	.85518	.85166	.84815	.84466
103	.88384	.88038	.87694	.87351	.87010	.86671	.86334	.85998	.85663	.85331
104	.89143	.88817	.88492	.88169	.87847	.87526	.87207	.86889	.86573	.86258
105	.89885	.89578	.89272	.88967	.88664	.88361	.88060	.87760	.87461	.87163
106	.90840	.90559	.90278	.89999	.89720	.89442	.89165	.88888	.88613	.88338
107	.91999	.91750	.91501	.91253	.91005	.90758	.90511	.90265	.90019	.89774
108	.93805	.93609	.93412	.93216	.93020	.92824	.92629	.92434	.92239	.92044

Age	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
109	.96900	.96800	.96700	.96600	.96500	.96400	.96300	.96200	.96100	.96000

Age	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
0	.01709	.01658	.01612	.01570	.01532	.01497	.01466	.01437	.01410	.01386
1	.00892	.00839	.00791	.00747	.00708	.00672	.00639	.00609	.00582	.00557
2	.00896	.00840	.00790	.00744	.00702	.00664	.00629	.00598	.00569	.00542
3	.00926	.00867	.00814	.00765	.00721	.00681	.00644	.00611	.00580	.00552
4	.00970	.00908	.00851	.00800	.00753	.00711	.00672	.00636	.00604	.00574
5	.01026	.00960	.00900	.00846	.00796	.00751	.00710	.00672	.00637	.00606
6	.01089	.01019	.00956	.00899	.00846	.00799	.00755	.00715	.00678	.00644
7	.01161	.01088	.01021	.00960	.00905	.00854	.00808	.00765	.00726	.00690
8	.01241	.01163	.01093	.01029	.00970	.00917	.00867	.00822	.00781	.00743
9	.01331	.01249	.01175	.01107	.01045	.00988	.00936	.00889	.00845	.00804
10	.01432	.01346	.01268	.01196	.01131	.01071	.01016	.00965	.00918	.00875
11	.01543	.01453	.01370	.01295	.01226	.01162	.01104	.01051	.01001	.00956
12	.01664	.01569	.01482	.01403	.01330	.01263	.01202	.01145	.01093	.01045
13	.01791	.01691	.01600	.01516	.01440	.01369	.01304	.01245	.01190	.01139
14	.01918	.01813	.01717	.01629	.01548	.01474	.01406	.01343	.01285	.01231
15	.02041	.01931	.01831	.01738	.01653	.01576	.01504	.01437	.01376	.01320
16	.02160	.02044	.01938	.01841	.01752	.01670	.01595	.01525	.01460	.01401
17	.02274	.02152	.02041	.01940	.01846	.01760	.01680	.01607	.01539	.01476
18	.02386	.02258	.02142	.02035	.01936	.01846	.01762	.01685	.01613	.01547
19	.02500	.02367	.02245	.02132	.02029	.01933	.01845	.01764	.01689	.01619
20	.02621	.02481	.02353	.02235	.02126	.02025	.01933	.01847	.01768	.01694
21	.02749	.02603	.02468	.02344	.02229	.02124	.02026	.01936	.01852	.01774
22	.02884	.02730	.02589	.02458	.02338	.02227	.02124	.02029	.01940	.01859
23	.03028	.02867	.02718	.02581	.02454	.02337	.02229	.02128	.02035	.01949
24	.03183	.03013	.02857	.02713	.02580	.02456	.02342	.02236	.02138	.02047
25	.03350	.03172	.03008	.02857	.02717	.02587	.02467	.02355	.02251	.02155
26	.03530	.03344	.03172	.03013	.02865	.02729	.02602	.02484	.02375	.02273
27	.03727	.03532	.03351	.03183	.03028	.02885	.02751	.02627	.02511	.02404
28	.03937	.03732	.03543	.03367	.03204	.03052	.02911	.02780	.02658	.02545
29	.04162	.03947	.03748	.03564	.03392	.03233	.03084	.02946	.02818	.02698
30	.04401	.04176	.03967	.03773	.03593	.03425	.03269	.03124	.02988	.02861
31	.04654	.04419	.04200	.03996	.03807	.03630	.03466	.03312	.03169	.03035
32	.04923	.04676	.04447	.04233	.04034	.03849	.03676	.03514	.03363	.03221
33	.05210	.04952	.04711	.04487	.04278	.04083	.03901	.03731	.03571	.03422
34	.05515	.05245	.04993	.04758	.04538	.04333	.04142	.03962	.03794	.03637
35	.05841	.05558	.05295	.05048	.04818	.04603	.04401	.04212	.04035	.03869
36	.06187	.05892	.05616	.05358	.05116	.04890	.04678	.04480	.04293	.04118
37	.06555	.06247	.05958	.05688	.05435	.05198	.04975	.04766	.04570	.04385
38	.06949	.06627	.06325	.06043	.05777	.05528	.05295	.05075	.04868	.04674
39	.07368	.07032	.06717	.06421	.06143	.05882	.05637	.05406	.05189	.04984
40	.07816	.07465	.07137	.06827	.06537	.06263	.06006	.05764	.05535	.05320
41	.08295	.07930	.07587	.07264	.06960	.06674	.06405	.06150	.05910	.05683
42	.08807	.08427	.08069	.07733	.07415	.07116	.06833	.06567	.06315	.06077
43	.09352	.08957	.08585	.08233	.07902	.07589	.07294	.07014	.06750	.06500
44	.09932	.09521	.09134	.08768	.08423	.08096	.07787	.07495	.07218	.06956
45	.10543	.10117	.09715	.09334	.08974	.08634	.08311	.08005	.07716	.07441
46	.11189	.10747	.10329	.09933	.09559	.09204	.08867	.08548	.08245	.07958
47	.11866	.11408	.10974	.10564	.10174	.09805	.09454	.09121	.08805	.08504
48	.12577	.12103	.11654	.11228	.10823	.10439	.10074	.09727	.09397	.09083
49	.13323	.12833	.12368	.11926	.11506	.11107	.10728	.10366	.10022	.09695
50	.14107	.13601	.13120	.12663	.12228	.11813	.11419	.11043	.10685	.10344
51	.14928	.14407	.13910	.13437	.12987	.12558	.12149	.11758	.11386	.11031
52	.15785	.15248	.14735	.14247	.13781	.13337	.12913	.12508	.12122	.11752
53	.16678	.16124	.15597	.15093	.14612	.14153	.13714	.13294	.12893	.12509
54	.17606	.17037	.16493	.15974	.15478	.15004	.14550	.14116	.13700	.13302
55	.18570	.17986	.17428	.16893	.16382	.15893	.15424	.14976	.14546	.14134
56	.19573	.18974	.18400	.17851	.17325	.16821	.16338	.15875	.15430	.15004
57	.20613	.20000	.19412	.18848	.18307	.17789	.17291	.16814	.16355	.15914
58	.21688	.21060	.20458	.19880	.19325	.18792	.18280	.17788	.17316	.16861
59	.22793	.22151	.21535	.20943	.20374	.19827	.19301	.18795	.18309	.17840
60	.23927	.23272	.22642	.22036	.21454	.20893	.20354	.19834	.19334	.18851
61	.25092	.24425	.23782	.23163	.22567	.21993	.21440	.20907	.20393	.19898
62	.26295	.25616	.24961	.24329	.23721	.23134	.22568	.22021	.21494	.20985
63	.27538	.26847	.26180	.25537	.24916	.24316	.23738	.23179	.22639	.22117
64	.28817	.28116	.27438	.26783	.26150	.25539	.24949	.24377	.23825	.23291
65	.30134	.29423	.28735	.28069	.27426	.26803	.26201	.25618	.25054	.24508
66	.31493	.30772	.30075	.29399	.28746	.28113	.27500	.26906	.26331	.25774
67	.32899	.32170	.31464	.30780	.30118	.29475	.28852	.28248	.27663	.27095
68	.34349	.33614	.32901	.32209	.31538	.30887	.30256	.29643	.29047	.28469
69	.35841	.35100	.34381	.33683	.33005	.32346	.31707	.31085	.30481	.29894

Age	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
70	.37366	.36620	.35896	.35193	.34509	.33844	.33197	.32568	.31957	.31362
71	.38916	.38167	.37440	.36732	.36043	.35372	.34720	.34084	.33466	.32864
72	.40486	.39736	.39006	.38295	.37602	.36927	.36270	.35629	.35005	.34396
73	.42074	.41323	.40591	.39878	.39182	.38504	.37843	.37198	.36568	.35955
74	.43685	.42934	.42202	.41488	.40791	.40110	.39446	.38798	.38165	.37547
75	.45326	.44577	.43846	.43132	.42435	.41754	.41088	.40438	.39802	.39181
76	.47004	.46259	.45530	.44818	.44122	.43442	.42776	.42125	.41488	.40865
77	.48718	.47979	.47255	.46547	.45853	.45175	.44511	.43861	.43225	.42601
78	.50467	.49735	.49017	.48314	.47626	.46951	.46290	.45643	.45008	.44386
79	.52239	.51515	.50806	.50110	.49427	.48758	.48102	.47459	.46828	.46209
80	.54018	.53304	.52603	.51916	.51242	.50580	.49930	.49292	.48666	.48052
81	.55788	.55085	.54396	.53718	.53053	.52399	.51757	.51126	.50507	.49898
82	.57540	.56851	.56173	.55506	.54851	.54207	.53574	.52951	.52339	.51737
83	.59274	.58598	.57933	.57279	.56635	.56001	.55378	.54765	.54161	.53567
84	.61002	.60341	.59690	.59049	.58418	.57796	.57184	.56582	.55988	.55403
85	.62734	.62090	.61454	.60828	.60211	.59603	.59004	.58414	.57832	.57258
86	.64455	.63828	.63210	.62600	.61999	.61406	.60821	.60244	.59675	.59113
87	.66139	.65531	.64930	.64337	.63752	.63175	.62605	.62043	.61488	.60939
88	.67783	.67194	.66612	.66037	.65469	.64908	.64354	.63807	.63267	.62733
89	.69387	.68817	.68254	.67698	.67148	.66605	.66068	.65537	.65012	.64493
90	.70947	.70398	.69855	.69318	.68786	.68261	.67742	.67228	.66719	.66217
91	.72437	.71908	.71385	.70867	.70354	.69847	.69345	.68848	.68357	.67870
92	.73823	.73314	.72810	.72310	.71816	.71326	.70841	.70361	.69886	.69415
93	.75109	.74618	.74132	.73650	.73173	.72700	.72232	.71768	.71308	.70852
94	.76312	.75839	.75370	.74905	.74445	.73988	.73536	.73087	.72643	.72202
95	.77459	.77004	.76552	.76104	.75660	.75220	.74783	.74350	.73920	.73494
96	.78543	.78105	.77670	.77238	.76810	.76386	.75964	.75546	.75131	.74720
97	.79550	.79128	.78709	.78293	.77880	.77470	.77063	.76659	.76258	.75860
98	.80498	.80091	.79687	.79286	.78888	.78492	.78099	.77709	.77322	.76937
99	.81428	.81036	.80647	.80261	.79877	.79496	.79117	.78741	.78367	.77995
100	.82336	.81959	.81586	.81214	.80845	.80478	.80113	.79751	.79390	.79032
101	.83234	.82873	.82515	.82158	.81804	.81451	.81101	.80753	.80406	.80062
102	.84119	.83774	.83431	.83089	.82750	.82412	.82076	.81742	.81409	.81078
103	.84999	.84670	.84342	.84016	.83691	.83368	.83046	.82726	.82408	.82091
104	.85944	.85632	.85321	.85011	.84703	.84396	.84090	.83786	.83483	.83182
105	.86866	.86570	.86276	.85982	.85690	.85399	.85109	.84820	.84532	.84245
106	.88065	.87792	.87520	.87248	.86978	.86708	.86440	.86172	.85905	.85638
107	.89530	.89286	.89042	.88799	.88557	.88315	.88073	.87833	.87592	.87352
108	.91849	.91654	.91460	.91266	.91072	.90879	.90685	.90492	.90299	.90106
109	.95900	.95800	.95700	.95600	.95500	.95400	.95300	.95200	.95100	.95000

Age	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
0	.01363	.01342	.01323	.01305	.01288	.01272	.01258	.01244	.01231	.01219
1	.00534	.00512	.00493	.00474	.00458	.00442	.00427	.00414	.00401	.00389
2	.00518	.00495	.00474	.00455	.00437	.00421	.00405	.00391	.00377	.00365
3	.00526	.00502	.00480	.00459	.00440	.00422	.00406	.00391	.00376	.00363
4	.00546	.00521	.00497	.00475	.00455	.00436	.00419	.00402	.00387	.00373
5	.00576	.00549	.00524	.00501	.00479	.00459	.00440	.00423	.00406	.00391
6	.00613	.00584	.00557	.00532	.00509	.00488	.00468	.00449	.00432	.00415
7	.00657	.00626	.00598	.00571	.00547	.00524	.00502	.00482	.00464	.00446
8	.00707	.00675	.00644	.00616	.00590	.00565	.00542	.00521	.00501	.00482
9	.00766	.00732	.00699	.00669	.00641	.00615	.00591	.00568	.00547	.00527
10	.00835	.00798	.00764	.00732	.00702	.00675	.00649	.00624	.00602	.00580
11	.00913	.00874	.00838	.00804	.00772	.00743	.00715	.00689	.00665	.00642
12	.01000	.00959	.00920	.00884	.00851	.00819	.00790	.00762	.00737	.00712
13	.01091	.01048	.01007	.00969	.00933	.00900	.00869	.00840	.00813	.00787
14	.01181	.01135	.01092	.01052	.01014	.00979	.00947	.00916	.00887	.00860
15	.01267	.01218	.01173	.01130	.01091	.01054	.01019	.00987	.00956	.00928
16	.01345	.01294	.01246	.01201	.01160	.01121	.01084	.01050	.01018	.00988
17	.01418	.01364	.01313	.01266	.01222	.01181	.01143	.01107	.01073	.01041
18	.01486	.01429	.01375	.01326	.01279	.01236	.01196	.01158	.01122	.01088
19	.01554	.01494	.01438	.01385	.01336	.01291	.01248	.01208	.01170	.01135
20	.01626	.01562	.01503	.01448	.01396	.01348	.01303	.01260	.01220	.01183
21	.01702	.01635	.01573	.01514	.01460	.01409	.01361	.01316	.01274	.01235
22	.01782	.01711	.01645	.01584	.01526	.01472	.01422	.01374	.01330	.01288
23	.01868	.01793	.01724	.01658	.01597	.01540	.01487	.01437	.01390	.01345
24	.01962	.01883	.01809	.01740	.01675	.01615	.01558	.01505	.01455	.01408
25	.02065	.01981	.01903	.01830	.01762	.01698	.01638	.01581	.01528	.01478
26	.02178	.02089	.02006	.01929	.01856	.01789	.01725	.01665	.01609	.01556
27	.02303	.02209	.02122	.02040	.01963	.01891	.01824	.01760	.01700	.01644
28	.02439	.02339	.02247	.02160	.02079	.02002	.01931	.01863	.01800	.01740
29	.02585	.02480	.02382	.02290	.02204	.02123	.02047	.01976	.01908	.01845
30	.02742	.02631	.02527	.02430	.02339	.02253	.02172	.02096	.02025	.01957

Age	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
31	.02910	.02793	.02683	.02579	.02482	.02391	.02306	.02225	.02149	.02077
32	.03089	.02965	.02849	.02739	.02636	.02540	.02449	.02363	.02282	.02206
33	.03282	.03151	.03028	.02912	.02803	.02701	.02604	.02513	.02427	.02346
34	.03489	.03350	.03220	.03097	.02982	.02873	.02771	.02674	.02583	.02497
35	.03713	.03567	.03429	.03299	.03177	.03061	.02953	.02850	.02753	.02661
36	.03953	.03798	.03653	.03515	.03386	.03263	.03148	.03039	.02936	.02838
37	.04211	.04048	.03894	.03748	.03611	.03481	.03359	.03243	.03134	.03030
38	.04490	.04318	.04155	.04001	.03856	.03719	.03589	.03466	.03350	.03239
39	.04791	.04609	.04437	.04274	.04120	.03975	.03837	.03707	.03583	.03466
40	.05116	.04924	.04742	.04571	.04408	.04254	.04108	.03970	.03839	.03714
41	.05469	.05267	.05075	.04894	.04722	.04559	.04405	.04258	.04119	.03987
42	.05851	.05638	.05436	.05245	.05063	.04891	.04728	.04573	.04425	.04285
43	.06263	.06039	.05827	.05625	.05433	.05252	.05079	.04915	.04759	.04610
44	.06707	.06472	.06248	.06035	.05834	.05642	.05459	.05286	.05121	.04963
45	.07180	.06933	.06698	.06474	.06262	.06059	.05867	.05684	.05509	.05342
46	.07685	.07425	.07178	.06943	.06720	.06507	.06304	.06110	.05926	.05750
47	.08218	.07946	.07687	.07440	.07205	.06981	.06768	.06564	.06369	.06183
48	.08784	.08499	.08228	.07969	.07722	.07487	.07262	.07047	.06842	.06646
49	.09382	.09085	.08801	.08530	.08271	.08024	.07788	.07562	.07346	.07140
50	.10018	.09707	.09410	.09127	.08856	.08597	.08349	.08112	.07885	.07667
51	.10691	.10367	.10057	.09761	.09477	.09206	.08946	.08697	.08459	.08231
52	.11399	.11061	.10738	.10429	.10132	.09849	.09577	.09316	.09066	.08826
53	.12142	.11791	.11454	.11132	.10823	.10526	.10242	.09969	.09707	.09456
54	.12921	.12556	.12206	.11870	.11548	.11239	.10942	.10657	.10383	.10120
55	.13738	.13359	.12995	.12646	.12311	.11989	.11679	.11382	.11096	.10820
56	.14595	.14202	.13824	.13462	.13113	.12778	.12456	.12146	.11847	.11560
57	.15491	.15084	.14693	.14317	.13955	.13607	.13272	.12949	.12638	.12338
58	.16424	.16004	.15599	.15209	.14834	.14473	.14125	.13789	.13465	.13153
59	.17390	.16955	.16537	.16134	.15746	.15371	.15010	.14662	.14325	.14001
60	.18387	.17939	.17507	.17091	.16689	.16302	.15927	.15566	.15217	.14880
61	.19420	.18958	.18513	.18084	.17669	.17268	.16881	.16506	.16145	.15795
62	.20494	.20020	.19561	.19119	.18691	.18277	.17877	.17490	.17115	.16753
63	.21613	.21126	.20654	.20199	.19758	.19331	.18918	.18518	.18131	.17757
64	.22774	.22274	.21791	.21322	.20869	.20429	.20004	.19592	.19192	.18805
65	.23979	.23467	.22971	.22490	.22025	.21573	.21135	.20710	.20299	.19899
66	.25233	.24709	.24202	.23709	.23231	.22767	.22318	.21881	.21457	.21045
67	.26543	.26009	.25489	.24985	.24496	.24021	.23560	.23111	.22676	.22252
68	.27908	.27363	.26833	.26319	.25819	.25332	.24860	.24400	.23954	.23519
69	.29324	.28769	.28230	.27705	.27195	.26699	.26216	.25746	.25288	.24843
70	.30783	.30219	.29671	.29137	.28618	.28112	.27619	.27139	.26672	.26216
71	.32277	.31706	.31150	.30608	.30079	.29564	.29063	.28573	.28096	.27631
72	.33803	.33225	.32661	.32112	.31575	.31052	.30542	.30044	.29559	.29084
73	.35356	.34772	.34201	.33645	.33101	.32571	.32053	.31547	.31053	.30571
74	.36943	.36354	.35778	.35215	.34666	.34129	.33604	.33091	.32590	.32100
75	.38574	.37980	.37400	.36833	.36278	.35735	.35205	.34686	.34178	.33681
76	.40256	.39660	.39076	.38505	.37947	.37400	.36864	.36340	.35827	.35324
77	.41991	.41394	.40808	.40235	.39674	.39124	.38585	.38056	.37539	.37032
78	.43777	.43180	.42594	.42020	.41457	.40906	.40365	.39834	.39314	.38803
79	.45602	.45007	.44422	.43849	.43287	.42735	.42193	.41661	.41139	.40627
80	.47449	.46856	.46275	.45704	.45143	.44592	.44051	.43519	.42997	.42484
81	.49300	.48712	.48134	.47566	.47008	.46460	.45921	.45391	.44870	.44357
82	.51145	.50563	.49990	.49427	.48873	.48328	.47792	.47265	.46746	.46235
83	.52983	.52407	.51841	.51284	.50735	.50195	.49663	.49139	.48624	.48116
84	.54828	.54261	.53702	.53151	.52609	.52075	.51549	.51030	.50519	.50015
85	.56693	.56135	.55586	.55044	.54510	.53983	.53464	.52952	.52447	.51949
86	.58560	.58013	.57474	.56943	.56418	.55901	.55390	.54886	.54389	.53898
87	.60398	.59864	.59337	.58817	.58303	.57795	.57294	.56799	.56310	.55828
88	.62206	.61685	.61170	.60662	.60159	.59663	.59173	.58688	.58209	.57736
89	.63980	.63474	.62972	.62477	.61987	.61503	.61024	.60551	.60083	.59620
90	.65719	.65227	.64741	.64259	.63783	.63312	.62846	.62385	.61928	.61477
91	.67388	.66912	.66440	.65973	.65511	.65053	.64600	.64152	.63708	.63269
92	.68949	.68487	.68030	.67577	.67129	.66685	.66245	.65809	.65378	.64950
93	.70401	.69954	.69511	.69072	.68637	.68205	.67778	.67355	.66935	.66519
94	.71765	.71332	.70902	.70477	.70055	.69636	.69222	.68810	.68403	.67998
95	.73072	.72653	.72237	.71825	.71416	.71010	.70608	.70209	.69813	.69421
96	.74311	.73906	.73504	.73105	.72709	.72316	.71926	.71539	.71155	.70774
97	.75465	.75073	.74684	.74297	.73914	.73533	.73155	.72780	.72407	.72037
98	.76555	.76175	.75798	.75424	.75052	.74683	.74317	.73953	.73591	.73232
99	.77626	.77260	.76895	.76534	.76174	.75817	.75462	.75109	.74759	.74411
100	.78676	.78323	.77971	.77622	.77274	.76929	.76586	.76245	.75906	.75569
101	.79719	.79379	.79040	.78703	.78368	.78035	.77704	.77375	.77048	.76722
102	.80749	.80422	.80096	.79772	.79450	.79130	.78811	.78494	.78178	.77864
103	.81775	.81461	.81149	.80838	.80529	.80221	.79914	.79609	.79306	.79003
104	.82881	.82582	.82284	.81988	.81693	.81399	.81106	.80815	.80525	.80236

Age	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
105	.83959	.83674	.83391	.83108	.82826	.82546	.82267	.81988	.81711	.81435
106	.85373	.85108	.84844	.84581	.84319	.84058	.83797	.83537	.83278	.83020
107	.87113	.86875	.86636	.86399	.86161	.85925	.85689	.85453	.85218	.84984
108	.89913	.89721	.89529	.89337	.89145	.88953	.88762	.88571	.88380	.88189
109	.94900	.94800	.94700	.94600	.94500	.94400	.94300	.94200	.94100	.94000

Age	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
0	.01208	.01197	.01187	.01177	.01168	.01159	.01151	.01143	.01135	.01128
1	.00378	.00367	.00358	.00348	.00340	.00331	.00323	.00316	.00309	.00302
2	.00353	.00342	.00331	.00322	.00312	.00304	.00295	.00288	.00280	.00273
3	.00350	.00339	.00327	.00317	.00307	.00298	.00289	.00281	.00273	.00265
4	.00359	.00347	.00335	.00324	.00313	.00303	.00294	.00285	.00276	.00268
5	.00377	.00363	.00351	.00339	.00327	.00317	.00306	.00297	.00288	.00279
6	.00400	.00386	.00372	.00359	.00347	.00335	.00325	.00314	.00305	.00295
7	.00430	.00414	.00400	.00386	.00373	.00360	.00349	.00338	.00327	.00317
8	.00465	.00448	.00432	.00417	.00403	.00390	.00378	.00366	.00354	.00344
9	.00508	.00490	.00473	.00457	.00442	.00428	.00414	.00402	.00389	.00378
10	.00560	.00541	.00523	.00506	.00490	.00475	.00460	.00446	.00433	.00421
11	.00620	.00600	.00581	.00563	.00546	.00529	.00514	.00499	.00485	.00472
12	.00689	.00668	.00647	.00628	.00610	.00593	.00576	.00560	.00545	.00531
13	.00763	.00740	.00718	.00698	.00678	.00660	.00642	.00626	.00610	.00595
14	.00834	.00810	.00787	.00766	.00745	.00726	.00707	.00689	.00673	.00657
15	.00901	.00875	.00851	.00828	.00807	.00786	.00767	.00748	.00730	.00714
16	.00959	.00932	.00907	.00883	.00860	.00839	.00818	.00799	.00780	.00762
17	.01011	.00983	.00956	.00930	.00907	.00884	.00862	.00842	.00822	.00804
18	.01057	.01027	.00999	.00972	.00947	.00923	.00900	.00879	.00858	.00839
19	.01101	.01070	.01040	.01012	.00985	.00960	.00936	.00914	.00892	.00871
20	.01148	.01115	.01083	.01054	.01026	.00999	.00974	.00950	.00927	.00905
21	.01197	.01162	.01129	.01098	.01068	.01040	.01014	.00988	.00964	.00941
22	.01249	.01211	.01176	.01143	.01112	.01082	.01054	.01027	.01002	.00978
23	.01304	.01264	.01227	.01192	.01159	.01127	.01098	.01069	.01042	.01017
24	.01364	.01322	.01283	.01246	.01210	.01177	.01145	.01115	.01087	.01060
25	.01431	.01387	.01345	.01306	.01268	.01233	.01199	.01168	.01137	.01109
26	.01506	.01459	.01415	.01373	.01333	.01295	.01260	.01226	.01194	.01163
27	.01591	.01541	.01494	.01449	.01407	.01367	.01329	.01293	.01259	.01226
28	.01684	.01631	.01580	.01533	.01488	.01445	.01405	.01367	.01330	.01296
29	.01785	.01728	.01675	.01624	.01577	.01531	.01488	.01447	.01408	.01372
30	.01893	.01833	.01776	.01723	.01672	.01623	.01578	.01534	.01493	.01453
31	.02010	.01946	.01885	.01828	.01773	.01722	.01673	.01627	.01582	.01540
32	.02134	.02066	.02002	.01940	.01883	.01828	.01776	.01726	.01679	.01634
33	.02270	.02197	.02128	.02063	.02002	.01943	.01887	.01835	.01784	.01736
34	.02415	.02338	.02265	.02195	.02130	.02067	.02008	.01951	.01897	.01846
35	.02574	.02492	.02414	.02340	.02270	.02203	.02140	.02080	.02022	.01967
36	.02746	.02658	.02575	.02496	.02422	.02350	.02283	.02218	.02157	.02098
37	.02932	.02838	.02750	.02666	.02586	.02510	.02438	.02369	.02303	.02241
38	.03135	.03035	.02941	.02851	.02766	.02685	.02608	.02534	.02464	.02397
39	.03355	.03249	.03149	.03053	.02962	.02876	.02793	.02715	.02640	.02568
40	.03596	.03484	.03377	.03275	.03178	.03086	.02998	.02914	.02833	.02757
41	.03861	.03742	.03628	.03520	.03416	.03318	.03224	.03134	.03048	.02966
42	.04152	.04025	.03903	.03788	.03678	.03573	.03473	.03377	.03285	.03198
43	.04468	.04333	.04205	.04082	.03965	.03853	.03746	.03644	.03546	.03453
44	.04813	.04670	.04533	.04403	.04278	.04159	.04045	.03936	.03832	.03732
45	.05183	.05032	.04887	.04748	.04616	.04489	.04368	.04252	.04141	.04034
46	.05582	.05421	.05267	.05121	.04980	.04846	.04717	.04593	.04475	.04362
47	.06006	.05836	.05673	.05518	.05369	.05226	.05089	.04958	.04832	.04711
48	.06459	.06279	.06107	.05943	.05785	.05634	.05488	.05349	.05216	.05087
49	.06942	.06752	.06571	.06397	.06230	.06070	.05916	.05768	.05626	.05490
50	.07459	.07259	.07068	.06884	.06708	.06538	.06376	.06219	.06069	.05924
51	.08012	.07801	.07599	.07406	.07220	.07041	.06869	.06703	.06544	.06391
52	.08596	.08375	.08163	.07959	.07763	.07574	.07392	.07218	.07049	.06887
53	.09214	.08982	.08759	.08544	.08338	.08139	.07948	.07763	.07586	.07415
54	.09867	.09623	.09389	.09164	.08946	.08737	.08536	.08342	.08154	.07974
55	.10556	.10301	.10055	.09819	.09591	.09371	.09159	.08955	.08757	.08567
56	.11283	.11016	.10759	.10511	.10272	.10042	.09819	.09605	.09397	.09197
57	.12050	.11771	.11502	.11243	.10993	.10751	.10518	.10293	.10075	.09864
58	.12852	.12562	.12281	.12011	.11749	.11496	.11252	.11016	.10787	.10567
59	.13687	.13385	.13092	.12810	.12537	.12273	.12017	.11770	.11531	.11299
60	.14554	.14240	.13935	.13641	.13356	.13080	.12813	.12555	.12305	.12063
61	.15457	.15130	.14813	.14507	.14210	.13923	.13644	.13375	.13113	.12860
62	.16402	.16063	.15734	.15415	.15107	.14808	.14518	.14237	.13964	.13699
63	.17393	.17042	.16700	.16370	.16049	.15738	.15437	.15144	.14860	.14584
64	.18429	.18065	.17712	.17369	.17036	.16714	.16400	.16096	.15800	.15513
65	.19511	.19135	.18769	.18415	.18070	.17735	.17410	.17094	.16787	.16488

Age	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
66	.20645	.20257	.19880	.19513	.19157	.18810	.18473	.18146	.17827	.17517
67	.21841	.21441	.21052	.20673	.20305	.19947	.19599	.19259	.18929	.18608
68	.23096	.22685	.22284	.21895	.21515	.21146	.20786	.20436	.20094	.19762
69	.24409	.23987	.23575	.23175	.22784	.22404	.22033	.21672	.21320	.20976
70	.25772	.25339	.24918	.24507	.24106	.23715	.23333	.22961	.22598	.22244
71	.27178	.26735	.26304	.25882	.25471	.25070	.24679	.24296	.23923	.23559
72	.28622	.28170	.27729	.27298	.26877	.26467	.26065	.25673	.25290	.24915
73	.30100	.29639	.29189	.28749	.28320	.27899	.27489	.27087	.26694	.26310
74	.31621	.31152	.30694	.30246	.29807	.29378	.28959	.28548	.28146	.27753
75	.33195	.32719	.32253	.31797	.31351	.30914	.30486	.30067	.29657	.29255
76	.34832	.34350	.33877	.33415	.32961	.32517	.32082	.31656	.31238	.30828
77	.36535	.36047	.35570	.35101	.34642	.34192	.33750	.33317	.32892	.32475
78	.38302	.37811	.37329	.36856	.36392	.35937	.35490	.35051	.34621	.34198
79	.40124	.39630	.39145	.38669	.38201	.37742	.37291	.36848	.36413	.35985
80	.41980	.41485	.40998	.40520	.40050	.39588	.39134	.38688	.38249	.37818
81	.43854	.43358	.42871	.42392	.41921	.41457	.41001	.40553	.40112	.39678
82	.45733	.45238	.44752	.44273	.43802	.43338	.42881	.42431	.41989	.41553
83	.47616	.47123	.46638	.46161	.45690	.45227	.44770	.44320	.43877	.43441
84	.49519	.49030	.48548	.48073	.47604	.47143	.46688	.46239	.45797	.45361
85	.51458	.50974	.50496	.50025	.49560	.49102	.48650	.48204	.47763	.47329
86	.53413	.52935	.52463	.51998	.51538	.51084	.50636	.50194	.49758	.49327
87	.55351	.54881	.54416	.53957	.53503	.53055	.52613	.52176	.51744	.51317
88	.57268	.56806	.56349	.55898	.55451	.55010	.54574	.54144	.53718	.53296
89	.59162	.58710	.58262	.57819	.57382	.56949	.56520	.56097	.55678	.55263
90	.61030	.60588	.60151	.59718	.59290	.58866	.58447	.58032	.57621	.57214
91	.62834	.62403	.61977	.61554	.61136	.60722	.60312	.59907	.59505	.59107
92	.64527	.64107	.63692	.63280	.62872	.62468	.62068	.61672	.61279	.60890
93	.66107	.65699	.65294	.64893	.64495	.64101	.63711	.63323	.62940	.62559
94	.67597	.67200	.66806	.66415	.66027	.65643	.65262	.64884	.64509	.64138
95	.69031	.68645	.68262	.67881	.67504	.67130	.66759	.66390	.66025	.65662
96	.70396	.70021	.69648	.69279	.68912	.68548	.68186	.67828	.67471	.67118
97	.71670	.71305	.70943	.70584	.70227	.69872	.69520	.69171	.68824	.68480
98	.72875	.72521	.72169	.71819	.71472	.71127	.70784	.70444	.70106	.69770
99	.74065	.73721	.73379	.73040	.72703	.72368	.72035	.71704	.71375	.71048
100	.75234	.74901	.74570	.74241	.73914	.73589	.73265	.72944	.72625	.72307
101	.76399	.76077	.75757	.75438	.75122	.74807	.74494	.74183	.73873	.73565
102	.77552	.77241	.76932	.76625	.76319	.76015	.75712	.75411	.75111	.74813
103	.78703	.78404	.78106	.77809	.77514	.77221	.76929	.76638	.76348	.76060
104	.79948	.79662	.79377	.79093	.78810	.78528	.78248	.77969	.77691	.77414
105	.81159	.80885	.80612	.80340	.80069	.79799	.79530	.79262	.78995	.78729
106	.82763	.82506	.82250	.81995	.81741	.81488	.81235	.80983	.80732	.80482
107	.84749	.84516	.84283	.84051	.83819	.83587	.83356	.83126	.82896	.82666
108	.87999	.87808	.87618	.87428	.87238	.87049	.86859	.86670	.86481	.86293
109	.93900	.93800	.93700	.93600	.93500	.93400	.93300	.93200	.93100	.93000

(f) *Effective dates.* This section applies after April 30, 1999.

[T.D. 8540, 59 FR 30117, June 10, 1994, as amended by T.D. 8819, 64 FR 23199, Apr. 30, 1999; T.D. 8886, 65 FR 36919, 36943, June 12, 2000]

TREATMENT OF EXCESS DISTRIBUTIONS OF TRUSTS APPLICABLE TO TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1969

§ 1.665(a)–0 Excess distributions by trusts; scope of subpart D.

Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, in the case of trusts other than foreign trusts created by U.S. persons, is designed generally to prevent a shift of tax burden to a trust from a beneficiary or beneficiaries. In the case of a foreign trust created by a U.S. person, subpart D is designed to prevent certain other tax avoidance possibilities. To accomplish these ends, subpart D provides special rules for treatment of amounts paid, credited, or required to be distributed by a complex trust (subject to subpart C (section 661 and following) of such part I) in any year in excess of distributable net income for that year. Such an excess distribution is defined as an accumulation distribution, subject to the limitations in section 665 (b) or (c). An accumulation distribution, in the case of a trust other than a foreign trust created by a U.S. person, is ''thrown back'' to each of the 5 preceding years in inverse order. In the case of a foreign trust created by a U.S.

person such an accumulation distribution is ''thrown back,'' in inverse order, to each of the preceding years to which the Internal Revenue Code of 1954 applies. That is, an accumulation distribution will be taxed to the beneficiaries of the trust in the year the distribution is made or required, but, in general, only to the extent of the distributable net income of those years which was not in fact distributed. However, with respect to a distribution by a trust other than a foreign trust created by a U.S. person, the resulting tax will not be greater than the aggregate of the taxes that would have been attributable to the amount thrown back to previous years had they been included in gross income of the beneficiaries in those years. In the case of a foreign trust created by a U.S. person, the resulting tax is computed under the provisions of section 669. To prevent double taxation, both in the case of a foreign trust created by a U.S. person, and a trust other than a foreign trust created by a U.S. person, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess thrown back and which are creditable under the provisions of chapter 1 of the Internal Revenue Code. Subpart D does not apply to any estate.

[T.D. 6989, 34 FR 733, Jan. 17, 1969]

§ 1.665(a)–1 Undistributed net income.

(a) The term *undistributed net income* means for any taxable year the distributable net income of the trust for that year as determined under section 643(a), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on the trust, as defined in § 1.665(d)–1.

The application of the rule in this paragraph to the first year of a trust in which income is accumulated may be illustrated by the following example:

Example. Assume that under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1954 the trust had distributable net income of $30,100 derived from royalties and the trustee made distributions of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,640 is paid. The undistributed net income of the trust as of the close of the taxable year 1954 is $7,460 computed as follows:

Distributable net income		$30,100
Less:		
Income currently distributable to A	$10,000	
Other amounts distributed to A	10,000	
Taxes imposed on the trust (see § 1.665(d)–1)	2,640	
		22,640
Undistributed net income		7,460

See also paragraphs (e)(1) and (f)(1) of § 1.668(b)–2 for additional illustrations of the application of the rule in this paragraph to the first year of a trust in which income is accumulated.

(b) The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see § 1.643(a)–6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on such trust by chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income. For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust (for any taxable year), by chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to the provisions of section 871 which is properly allocable to the undistributed portion of the distributable net income. See § 1.665(d)–1. The amount of taxes imposed pursuant to the provisions of section 871 is the difference between the total tax imposed pursuant to the provisions of that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in

this paragraph may be illustrated by the following examples:

Example 1. A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money or property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that $7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1963 the trust had income of $10,000 from dividends of a U.S. corporation (on which Federal income taxes of $3,000 were imposed pursuant to the provisions of section 871 and withheld under section 1441 resulting in the receipt by the trust of cash in the amount of $7,000), $20,000 in capital gains from the sale of stock of a Country Y corporation, and $30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. The trustee did not file a U.S. income tax return for the taxable year 1963. The distributable net income of the trust before distributions to the beneficiary for 1963 is $60,000 ($57,000 of which is cash). During 1963 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income or $30,000. Thus, the U.S. beneficiary is treated as having had distributed to him $5,000 (composed of $3,500 as a cash distribution and $1,500 as the tax imposed pursuant to the provisions of section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; $10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and $15,000 in cash, representing one-half of the income from Country X sources for a total of $30,000. The undistributed net income of the trust at the close of taxable year 1963 is $28,500 computed as follows:

Distributable net income		$60,000
Less:		
(1) Amounts distributed to the beneficiary—.		
Income currently distributed to the beneficiary	$7,000	
Other amounts distributed to the beneficiary	21,500	
Taxes under sec. 871 deemed distributed to the beneficiary	1,500	
Total amounts distributed to the beneficiary	30,000	
(2) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1)	1,500	
Total		31,500
Undistributed net income		28,500

Example 2. The facts are the same as in example 1 except that property has been transferred to the trust by a person other than a U.S. person, and during 1963 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X in 1963.

(1) The undistributed net income of the foreign trust created by a U.S. person for 1963 is $17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):		
60% of $10,000 U.S. dividends		$6,000
60% of $20,000 Country X capital gains		12,000
60% of $30,000 Country X dividends		18,000
Total		36,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (60% of $7,000)	$4,200	
Other amounts distributed to the beneficiary (60% of $21,500)	12,900	
Taxes under sec. 871 deemed distributed to the beneficiary (60% of $1,500)	900	
Total amounts distributed to the beneficiary	18,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1) (60% of $1,500)	$900	
Total		$18,900
Undistributed net income		17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1963 is $11,400, computed as follows:

Distributed net income (40% of each item of gross income of entire trust)		
40% of $10,000 U.S. dividends		$4,000
40% of $20,000 Country X capital gains		8,000
40% of Country X dividends		12,000
Total		24,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (40% of $7,000)	$2,800	
Other amounts distributed to the beneficiary (40% of $21,500)	8,600	
Taxes under sec. 871 deemed distributed to the beneficiary (40% of $1,500)	600	
Total amounts distributed to the beneficiary	12,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1) (40% of $1,500)	$600	
Total		$12,600
Undistributed net income		11,400

(c) However, the undistributed net income for any year to which an accumulation distribution for a later year may be thrown back may be reduced by accumulation distributions in intervening years and also by any taxes imposed on the trust which are deemed to be distributed under section 666 by reason of the accumulation distributions. On the other hand, undistributed net income for any year will not be reduced by any distributions in an intervening year which are excluded from the definition of an accumulation distribution under section 665(b), or which are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (f)(5) of §1.668(b)–2 for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

[T.D. 6989, 34 FR 733, 741, Jan. 17, 1969]

§1.665(b)–1 Accumulation distributions of trusts other than certain foreign trusts; in general.

(a) Subject to the limitations set forth in §1.665(b)–2, in the case of a trust other than a foreign trust created by a U.S. person, the term *accumulation distribution* for any taxable year means an amount (if in excess of $2,000), by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person's legal obligation as that term is used in §1.662(a)–4.) If the distribution as so computed is $2,000 or less, it is not an accumulation distribution within the meaning of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. If the distribution exceeds $2,000, then the full amount is an accumulation distribution for the purposes of subpart D.

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, in the case of a trust other than a foreign trust created by a U.S. person, the provisions of subpart D will not apply unless there is undistributed net income in at least one of the five preceding taxable years. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples (it is assumed in each case that the exclusions provided in §1.665(b)–2 do not apply):

Example 1. A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1956, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently (section 661(a)(1))		10,000
Other amounts distributed (section 661(a)(2))		10,000
Distributable net income	$15,000	
Less: Income required to be distributed currently	10,000	
Balance of distributable net income		5,000
Accumulation distribution		5,000

Example 2. Under the terms of the trust instrument, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643(b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))		15,000
Other amounts distributed (section 661(a)(2))		5,000
Distributable net income	$13,000	

Less: Income required to be distributed currently to A	15,000	
Balance of distributable net income		0
Accumulation distribution to B		5,000

Example 3. Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution	$20,000
Less: income required to be distributed currently	0
Other amounts distributed (section 661(a)(2))	20,000
Distributable net income	17,000
Accumulation distribution	3,000

(d) There are not taken into account, in computing the accumulation distribution for any taxable year, any amounts deemed distributed in that year because of an accumulation distribution in a later year.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 734, Jan. 17, 1969]

§ 1.665(b)–2 Exclusions from accumulation distributions in the case of trusts (other than a foreign trust created by a U.S. person).

(a) In the case of a trust other than a foreign trust created by a U.S. person, certain amounts paid, credited, or required to be distributed to a beneficiary are excluded under section 665(b) in determining whether there is an accumulation distribution for the purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code. These exclusions are solely for the purpose of determining the amount allocable to preceding years under section 666 and in no way affect the determination under subpart C (section 661 and following) of such part I of the beneficiary's tax liability for the year of distribution. Further, amounts excluded from accumulation distributions do not reduce the amount of undistributed net income for the 5 years preceding the year of distribution.

(b) The amounts excluded from the computation of an accumulation distribution are discussed in the following subparagraphs:

(1) *Distributions from accumulations while a beneficiary is under 21.* (i) The first exception to the definition of an accumulation distribution is for amounts paid, credited, or required to be distributed to a beneficiary who was under 21 years of age or unborn when it was accumulated. A distribution is to be considered as so paid, credited, or required to be distributed to the extent, and only to the extent, that there is no undistributed net income for taxable years preceding the year of distribution other than undistributed net income accumulated while the beneficiary was under 21. If a distribution can be made from income accumulated either before or after a beneficiary reaches 21, it will be considered as made from the most recently accumulated income, and it will be so considered even though the governing instrument directs that distributions be charged first against the earliest accumulations.

(ii) As was indicated in paragraph (a) of this section, a distribution of an amount excepted from the definition of an accumulation distribution will not reduce undistributed net income for the purpose of determining the effect of a future accumulation distribution. Thus, a distribution to a beneficiary of income accumulated before he reached 21 would not reduce the undistributed net income includible in a future accumulation distribution to another beneficiary. However, all future distributions to the same beneficiary, or to another beneficiary to whom a distribution would be excepted under the provisions of this subparagraph, would be excepted from the definition of an accumulation distribution to the extent that they could not be paid, credited, or required to be distributed from other accumulated income.

(iii) The following examples illustrate the application of the foregoing rules of this subparagraph (in each of these examples it is assumed that the exceptions in section 665(b) (2), (3), and (4) do not apply):

(a) Income is to be accumulated until A reaches 21 when the corpus and accumulated income are to be distributed

to him. The distribution is not an accumulation distribution.

(b) Income is to be accumulated until A is 21, when it is to be distributed to him but the corpus is to remain in trust. A distribution of the accumulated income to A when he reaches 21 is not an accumulation distribution.

(c) Income is to be accumulated and added to corpus until A reaches 21, when he is to receive one-third of the corpus (including accumulations). Thereafter all the income is to be paid to A until he is 23 when the remaining corpus (including accumulations) is to be paid to him. If A dies under that age any undistributed portion is to be paid to B. Distributions to A at 21 and 23 out of accumulations are not accumulation distributions even though they include accumulated income. However, if A died at the age of 22, when B was 23, a distribution to B would be an accumulation distribution to the extent of income accumulations since B reached 21, and the amount of undistributed net income includible in the distribution will not be reduced by the previous distribution to A.

(d) Income is to be accumulated and added to corpus until A is 21. After he is 21, he is entitled to all the income and, in addition, to distributions of corpus in the discretion of the trustee. When he reaches 25 he is entitled to the corpus. Distributions to A are not accumulation distributions, whether they are discretionary or upon termination of the trust.

(e) The facts are the same as in the preceding example, except that income is to be accumulated until A is 23. Distributions to A are accumulation distributions to the extent of income accumulated after A reached 21.

(f) Income may be distributed among a testator's children or accumulated and added to corpus until the youngest child is 21, when the corpus is to be distributed to the testator's then living descendants. Upon termination of the trust, the corpus is distributed to A, age 21; B, age 23; and C, the child of a deceased child, age 3. The distributions to A and C are not accumulation distributions. The distribution to B is an accumulation distribution to the extent of income accumulated after he reaches 21. (If the terms of the trust were such that it was subject to the separate share treatment under section 663(c), the distribution to B would be an accumulation distribution only to the extent of income accumulated for B's separate share since he reached 21.)

(g) Income may be distributed to A or accumulated and added to corpus during A's life. Upon the death of A the corpus is to be distributed to B. B is 23 at A's death. The distribution is an accumulation distribution to the extent of income accumulated since B reached 21.

(2) *Emergency distributions.* The second exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary to meet his emergency needs. Whether or not a distribution falls within this exclusion depends upon the facts and circumstances causing the distribution. A distribution based upon an unforeseen or unforeseeable combination of circumstances requiring immediate help to the beneficiary would qualify for the exclusion. However, the beneficiary must be in actual need of the distribution and the fact that he had other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs. Ordinary distributions for the support, maintenance, or education of the beneficiary would not qualify for the exclusion.

(3) *Certain distributions at specified ages.* The third exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary upon the beneficiary's attaining a specified age or ages; provided, (i) the total number of such distributions with respect to that beneficiary cannot exceed 4; (ii) the period between each such distribution is 4 years or more; and (iii) on January 1, 1954, such distributions were required by the specific terms of the governing instrument. Any discretionary invasion of corpus at other times is not excluded under this subparagraph, but does not affect the status of distributions that would otherwise be excluded. If more than four distributions are required to be made to a particular beneficiary at specified ages if he survives to receive them, none of the distributions will be excluded, even though the

beneficiary dies before he receives more than four. On the other hand, a direction to make additional distributions to a remainderman will not affect the status of distributions required to be made to the primary beneficiary. For example, a trust agreement provided on January 1, 1954, that when A reached age 25 he would receive one-eighth of the corpus and accumulated income, as then constituted, and similar distributions at ages 30, 35, and 40. It also provided for similar distributions to B after A's death, and for additional discretionary distributions to both A and B. Required distributions to both A and B are excluded, regardless of whether discretionary distributions are made, but discretionary distributions are not excluded. On the other hand, if an additional distribution to A was directed when he reached 45, no distributions to him would be excluded, regardless of when he died.

(4) *Certain final distributions.* (i) The last exception to the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary as a final distribution of a trust if the final distribution is made more than 9 years after the date of the last transfer to such trust.

(ii) The term *last transfer to such trust* includes only transfers, whether by the original grantor or by a third person, made with a donative intent. A transfer arising out of a property right held by the trust is excluded, such as a transfer by a debtor in satisfaction of his indebtedness, or a distribution in liquidation or reorganization of a corporation. If the terms of two or more trusts include cross-remainders on the deaths of life beneficiaries, the donative transfers occurred at the time the trusts were created. The addition of the corpus of one trust to that of another when a remainder falls in is therefore not a new transfer within the meaning of section 665(b)(4).

(iii) For example, under the terms of a trust created July 1, 1950, with an original corpus of $100,000, by H for the benefit of his wife, W, the income of the trust is to be accumulated and added to corpus. Upon the expiration of a 10-year period, the trust is to terminate and its assets, including all accumulated income, are to be distributed to W. No transfers were made by H or other persons to the trust after it was created. Both the trust and W file returns on the calendar year basis. In accordance with its terms, the trust terminated on June 30, 1960, and on August 1, 1960, the trustee made a final distribution of the assets of the trust to W, consisting of investments derived from $100,000 of donated principal, accumulated income of $30,000 attributable to the period July 1, 1950, through December 31, 1959, and income of $3,000 attributable to the period the trust was in existence during 1960. Subpart D is inapplicable to the $3,000 of income of the trust for 1960 since that amount would be deductible by the trust and includible in W's gross income for that year to the extent provided in subpart C. However, the balance of the distribution will qualify as an exclusion from the provisions of subpart D.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(b)–3 Exclusions under section 663(a)(1).

Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, has no application to an amount which qualifies as an exclusion under section 663(a)(1), relating to gifts, bequests, etc.

§ 1.665(c)–1 Accumulation distributions of certain foreign trusts; in general.

(a) In the case of a foreign trust created by a U.S. person, the term *accumulation distribution* for any taxable year means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under circumstances specified in section 677(b) and section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.)

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, the provisions of subpart D will not apply unless there is undistributed net income in at least one of the preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the examples provided in paragraph (c) of § 1.665(b)–1.

[T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(c)–2 Indirect payments to the beneficiary.

(a) *In general.* Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) *Limitation.* In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

[T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(d)–1 Taxes imposed on the trust.

(a) For the purpose of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, the term *taxes imposed on the trust* means (for any taxable year) the amount of Federal income taxes which are properly allocable to the undistributed portion of the distributable net income. This amount is the difference between the total taxes of the trust for the year and the amount which would have been paid by the trust had all of the distributable net income, as determined under section 643(a), been distributed. Thus, in determining the amount of taxes imposed on the trust for the purposes of subpart D, there is excluded the portion of the taxes paid by the trust which is attributable to items of gross income which are not includible in distributable net income, such as capital gains allocable to corpus. The rule stated in this paragraph may be illustrated by the following example:

Example. (1) Under the terms of a trust which reports on the calendar year basis the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1954, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribution of $10,000 to A. The taxes imposed on the trust for the purposes of this subpart are $2,713, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is $18,000 (royalties of $20,000 less expenses of $2,000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gains		10,000
Gross income		30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		12,900
Total income taxes		3,787

(3) The amount of taxes which would have been paid by the trust, had all of the distributable net income ($18,000) of the trust been distributed to A, is $1,074, computed as follows:

Taxable income of the trust	$12,900
Less: Undistributed portion of distributable net income ($18,000 − $10,000)	8,000
Balance of taxable income	4,900
Income taxes on $4,900	1,074

(4) The amount of taxes imposed on the trust as defined in this paragraph is $2,713, computed as follows:

Total taxes	$3,787
Taxes which would have been paid by the trust had all of the distributable net income been distributed	1,074
Taxes imposed on the trust as defined in this paragraph	2,713

(b) If in any subsequent year an accumulation distribution is made by the trust which results in a throwback to the taxable year, the taxes of the taxable year allocable to the undistributed portion of distributable net income (the taxes imposed on the trust), after the close of the subsequent year, are the taxes prescribed in paragraph (a) of this section reduced by the taxes of the taxable year allowed as credits to beneficiaries on account of amounts deemed distributed on the last day of the taxable year under section 666. See paragraph (f)(4) of § 1.668(b)–2 for an illustration of the application of this paragraph.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960. Redesignated by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(e)–1 Preceding taxable year.

(a) *Definition*. For purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code of 1954, the term *preceding taxable year* does not include any taxable year to which such part I does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of such subpart D may not, in general, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a trust (reporting on the calendar year basis) makes a distribution during the calendar year 1955 of income accumulated during prior years and the distribution exceeds the distributable net income of 1955, the excess distribution may be allocated under such subpart D to 1954, but it may not be allocated to 1953 and preceding years, since the Internal Revenue Code of 1939 applies to those years.

(b) *Simple trusts subject to subpart D*. An accumulation distribution may be properly allocated to a preceding taxable year in which the trust qualified as a simple trust (that is, qualified for treatment under subpart B (section 651 and following) of such part I). In such event, the trust is treated for such preceding taxable year in all respects as if it were a trust to which subpart C (section 661 and following) of such part I applies. An example of such a circumstance would be in the case of a trust (required under the trust instrument to distribute all of its income currently) which received in the preceding taxable year extraordinary dividends or taxable stock dividends which the trustee in good faith allocated to corpus, but which are subsequently determined to be currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)–4. The trust would qualify for treatment under such subpart C for the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and would be treated as other amounts properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a)(2). Also, in the case of a trust other than a foreign trust created by a U.S. person, the distribution would qualify as an accumulation distribution for the purposes of such subpart D if in excess of $2,000 and not excepted under section 665(b) and the regulations thereunder. In the case of a foreign trust created by a U.S. person, the distribution, regardless of the amount, would qualify as an accumulation distribution for the purposes of subpart D. For the purposes only of such subpart D, the trust would be treated as subject to the provisions of such subpart C for the preceding taxable year in which the extraordinary or taxable stock dividends were received and in computing undistributed net income for such preceding year, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in the later year were made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 735, Jan. 17, 1969. Redesignated by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(e)–2 Application of separate share rule.

In trusts to which the separate share rule of section 663(c) is applicable for any taxable year, subpart D (section 665 and following), part I, subchapter J, of the Code, is applied as if each share were a separate trust. Thus, ''undistributed net income'' and the amount of an ''accumulation distribution'' are computed separately for each share. The ''taxes imposed on the trust'' are allocated as follows:

(a) There is first allocated to each separate share that portion of the ''taxes imposed on the trust'', computed before the allowance of credits under section 642(a), which bears the same relation to the total that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(1) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a) (5), (6), and (7); and

(2) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(b) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the ''taxes imposed on the trust'' which bear the same relation to the total that the items of income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust. The amount of taxes imposed on the trust allocable to a separate share as so determined is then reduced by the amount of the taxes allowed under sections 667 and 668 as a credit to a beneficiary of the separate share on account of any accumulation distribution determined for any taxable year intervening between the year for which the determination is made and the year of an accumulation distribution with respect to which the determination is made. See paragraph (b) of § 1.665(d)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969. Redesignated by T.D. 6989, 34 FR 736, Jan. 17, 1969]

§ 1.666(a)–1A Amount allocated.

(a) *In general.* In the case of a trust that is subject to subpart C of part I of subchapter J of chapter 1 of the Code (relating to estates and trusts that may accumulate income or that distribute corpus), section 666(a) prescribes rules for determining the taxable years from which an accumulation distribution will be deemed to have been made and the extent to which the accumulation distribution is considered to consist of undistributed net income. In general, an accumulation distribution made in taxable years beginning after December 31, 1969, is deemed to have been made first from the earliest preceding taxable year of the trust for which there is undistributed net income. An accumulation distribution made in a taxable year beginning before January 1, 1970, is deemed to have been made first from the most recent preceding taxable year of the trust for which there is undistributed net income. See § 1.665(e)–1A for the definition of ''preceding taxable year.''

(b) *Distributions by domestic trusts*—(1) *Taxable years beginning after December 31, 1973.* An accumulation distribution made by a trust (other than a foreign trust created by a U.S. person) in any taxable year beginning after December 31, 1973, is allocated to the preceding taxable years of the trust (defined in § 1.665(e)–1A(a)(1)(ii) as those beginning after December 31, 1968) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first to be allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See paragraph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1977, a domestic trust reporting on the calendar year basis makes an accumulation distribution of $33,000. Therefore, years before 1969 are ignored. In 1969, the trust had $6,000 of undistributed net income; in 1970, $4,000; in 1971, none; in 1972, $7,000; in 1973, $5,000; in 1974, $8,000; in 1975, $6,000; and $4,000 in 1976. The accumulation distribution is deemed distributed $6,000 in 1969, $4,000 in 1970, none in 1971, $7,000 in 1972, $5,000 in 1973, $8,000 in 1974, and $3,000 in 1975.

(2) *Taxable years beginning after December 31, 1969, and before January 1, 1974.* If a trust (other than a foreign trust created by a U.S. person) makes an accumulation distribution in a taxable year beginning after December 31, 1969, and before January 1, 1974, the distribution will be deemed distributed in the same manner as accumulation distributions qualifying under subparagraph (1) of this paragraph, except that the first year to which the distribution may be thrown back cannot be earlier than the fifth taxable year of the trust preceding the year in which the accumulation distribution is made. Thus, for example, in the case of an accumulation distribution made in the taxable year of a domestic trust which begins on January 1, 1972, the taxable year of the trust beginning on January 1, 1967, would be the first year in which the distribution was deemed made, assuming that there was undistributed net income for 1967. See also § 1.665(e)–1A(a)(1). The provisions of this subparagraph may be illustrated by the following example:

Example. In 1973, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1968, the fifth year preceding 1973, the trust had $7,000 of undistributed net income; in 1969, none; in 1970, $12,000; in 1971, $4,000; in 1972, $4,000. The accumulation distribution is deemed distributed in the amounts of $7,000 in 1968, none in 1969, $12,000 in 1970, $4,000 in 1971, and $2,000 in 1972.

(3) *Taxable years beginning after December 31, 1968, and before January 1, 1970.* Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(c) *Distributions by foreign trusts*— (1) *Foreign trusts created solely by U.S. persons*—(i) *Taxable years beginning after December 31, 1969.* If a foreign trust created by a U.S. person makes an accumulation distribution in any taxable year beginning after December 31, 1969, the distribution is allocated to the trust's preceding taxable years (defined in § 1.665(e)–1A(a)(2) as those beginning after Dec. 31, 1953, and ending after Aug. 16, 1954) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See paragraph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subdivision may be illustrated by the following example:

Example. In 1971, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of $50,000. In 1961, the trust had $12,000 of undistributed net income; in 1962, none; in 1963, $10,000; in 1964, $8,000; in 1965, $5,000; in 1966, $14,000; in 1967, none; in 1968, $3,000; in 1969, $2,000; and in 1970, $1,000. The accumulation distribution is deemed distributed in the amounts of $12,000 in 1961, none in 1962, $10,000 in 1963, $8,000 in 1964, $5,000 in 1965, $14,000 in 1966, none in 1967, and $1,000 in 1968.

(ii) *Taxable years beginning after December 31, 1968, and before January 1, 1970.* Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(2) *Foreign trusts created partly by U.S. persons*—(i) *Taxable years beginning after December 31, 1969.* If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1969, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire foreign trust. Accordingly, an accumulation distribution of such a trust is composed of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the earliest preceding taxable year, as defined in § 1.665(e)–1A(a), of the applicable foreign trusts, to the extent of the undistributed net income for the such trust for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the earliest accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year beginning after December 31, 1969, the distribution is included in the beneficiary's income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The provisions of this subdivision may be illustrated by the following example:

Example. A trust is created in 1962 under the laws of Country X by the transfer to a trustee in Country X of property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1974, the trust makes an accumulation distribution of $150,000 to the beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of § 1.643(d)–1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of

§ 1.665(a)–1A. For taxable years 1962 through 1973, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income-portion of the trust created by a U.S. person	Undistributed net income-portion of the trust created by a person other than a U.S. person
1962 ...	$7,000	$4,000
1963 ...	12,000	7,000
1964 ...	None	None
1965 ...	11,000	5,000
1966 ...	8,000	3,000
1967 ...	None	None
1968 ...	4,000	2,000
1969 ...	17,000	8,000
1970 ...	16,000	9,000
1971 ...	None	None
1972 ...	25,000	12,000
1973 ...	20,000	10,000
Totals	120,000	60,000

The accumulation distribution in the amount of $150,000 is deemed to have been distributed in the amount of $100,000 (120,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a U.S. person and in the amount of $39,000, which is less than $50,000 (60,000/180,000×$150,000), from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1962	$7,000	None
1963	12,000	None
1964	None	None
1965	$11,000	None
1966	8,000	None
1967	None	None
1968	4,000	None
1969	17,000	$8,000
1970	16,000	9,000
1971	None	None
1972	$25,000	$12,000
1973	None	10,000
Totals	100,000	39,000

Pursuant to this paragraph, the accumulation distribution in the amount of $100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's income for 1974, as the amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's income for 1974 to the extent of the undistributed net income of the trust for the preceding years beginning after December 31, 1968. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person, only the undistributed net income for the years 1969 through 1973, which totals $39,000, is includible in the beneficiary's income for 1974. Thus, of the $150,000 distribution made in 1974, the beneficiary is required to include a total of $139,000 in his income for 1974. The balance of $11,000 is deemed to represent a distribution of corpus.

(ii) *Taxable years beginning after December 31, 1968, and before January 1, 1970.* Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(3) *Foreign trusts created by non-U.S. persons.* To the extent that a foreign trust is a foreign trust created by a person other than a U.S. person, an accumulation distribution is included in the beneficiary's income for the year paid, credited, or required to be distributed to the extent provided under paragraph (b) of this section.

(d) *Reduction of undistributed net income for prior accumulation distributions.* For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is reduced by the amount from such year deemed distributed in any accumulation distribution of undistributed net income made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust has undistributed net income for 1974 and makes accumulation distributions during the taxable years 1978 and 1979, in determining that part of the 1979 accumulation distribution that is thrown back to 1974 the undistributed net income for 1974 is first reduced by the amount of the undistributed net income for 1974 deemed distributed in the 1978 accumulation distribution.

(e) *Rule when no undistributed net income.* If, before the application of the provisions of subpart D to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is undistributed net income deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed net income for 1970, then no portion of the 1975 accumulation distribution is undistributed net income deemed distributed on the last day of 1970.

[T.D. 7204, 37 FR 17143, Aug. 25, 1972]

§ 1.666(b)–1A Total taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the ''taxes imposed on the trust attributable to the undistributed net income'' (as defined in § 1.665(d)–1A(b)) for such preceding taxable year is also deemed distributed under section 661(a)(2). For example, a trust has undistributed net income of $8,000 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed net income are $3,032. During the taxable year 1977, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under § 1.666(a)–1A to have been distributed on the last day of 1974. The 1977 accumulation distribution is not less than the 1974 undistributed net income. Accordingly, the taxes of $3,032 imposed on the trust attributable to the undistributed net income for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of § 1.666(a)–1A.

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§ 1.666(c)–1A Pro rata portion of taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is also deemed distributed under section 661(a)(2). The additional amount is equal to the ''taxes imposed on the trust attributable to the undistributed net income'' (as defined in § 1.665(a)–1A(b)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the accumulation distribution allocated to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year. See paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in § 1.666(c)–2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of § 1.666(a)–1A and paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.666(c)–2A.

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§ 1.666(c)–2A Illustration of the provisions of section 666 (a), (b), and (c).

The application of the provisions of §§ 1.666(a)–1A, 1.666(b)–1A, and 1.666(c)–1A may be illustrated by the following examples:

Example 1. (a) A trust created on January 1, 1974, makes accumulation distributions as follows:

1979	$7,000
1980	26,000

For 1974 through 1978, the undistributed portion of distributable net income, taxes imposed on the trust attributable to the undistributed net income, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust attributable to the undistributed net income	Undistributed net income
1974	$12,100	$3,400	$8,700
1975	16,100	5,200	10,900
1976	6,100	1,360	4,740
1977	None	None	None
1978	10,100	2,640	7,460

The trust has no undistributed capital gain.

(b) Since the entire amount of the accumulation distribution for 1979 ($7,000) is less than the undistributed net income for 1974 ($8,700), an additional amount of $2,736 (7,000/8,700×$3,400) is deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1980, the amount of undistributed net income for 1974 will reflect the accumulation distribution for 1979. The undistributed net income for 1974 will then be $1,700 and the taxes imposed on the trust for 1974 will be $664, determined as follows:

Undistributed net income as of the close of 1974	$8,700
Less: Accumulation distribution (1979)	7,000
Balance (undistributed net income as of the close of 1979)	1,700
Taxes imposed on the trust attributable to the undistributed net income as of the close of 1979 (1,700/8,700×$3,400)	664

(d) The accumulation distribution of $26,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of $24,800, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $9,864, the total taxes imposed on the trust attributable to the undistributed net income for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1974	$1,700	$664
1975	10,900	5,200
1976	4,740	1,360
1977	None	None
1978	7,460	2,640
1979	None	None

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1974 was accumulated. The distributable net income of the trust for the taxable year 1974 is $20,100 and the income taxes paid by the trust for 1974 attributable to the undistributed net income are $7,260. All of the income for 1975 and 1976 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of $5,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1974, is $12,840, computed as follows:

Distributable net income	$20,100
Less: Taxes imposed on the trust attributable to the undistributed net income	7,260
Undistributed net income as of the close of 1974	12,840

(c) The accumulation distribution of $5,420 made during the taxable year 1975 is deemed under section 666(a) to have been made on December 31, 1974. Since this accumulation distribution is less than the 1974 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1974 is also deemed under section 666(c) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974 is $8,484, computed as follows:

Accumulation distribution	$5,420
Taxes deemed distributed (5,420/12,840×$7,260)	3,064
Total	8,484

(d) After the application of the provisions of subpart D to the accumulation distribution of 1975, the undistributed net income of the trust for 1974 is $7,420, computed as follows:

Undistributed net income as of the close of 1974	$12,840

Less: 1975 accumulation distribution deemed distributed on December 31, 1974 (paragraph (c) of this example)	5,420
Undistributed net income for 1974 as of the close of 1975	7,420

(e) The taxes imposed on the trust attributable to the undistributed net income for the taxable year 1974, as adjusted to give effect to the 1975 accumulation distribution, amount to $4,196, computed as follows:

Taxes imposed on the trust attributable to undistributed net income as of the close of 1974	$7,260
Less: Taxes deemed distributed in 1974	3,064
Taxes attributable to the undistributed net income determined as of the close of 1975	4,196

(f) The accumulation distribution of $5,420 made during the taxable year 1976 is, under section 666(a), deemed a distribution to X on December 31, 1974, within the meaning of section 661(a)(2). Since the accumulation distribution is less than the 1974 adjusted undistributed net income of $7,420, the trust is deemed under section 666(c) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the accumulation distribution made in 1976, is $8,484, computed as follows:

Accumulation distribution	$5,420
Taxes deemed distributed (5,420/7,420×$4,196)	3,064
Total	8,484

(g) After the application of the provisions of subpart D to the accumulation distribution of 1976, the undistributed net income of the trust for 1974 is $2,000, computed as follows:

Undistributed net income for 1974 as of the close of 1975	$7,420
Less: 1976 accumulation distribution deemed distributed on December 31, 1974 (paragraph (f) of this example)	5,420
Undistributed net income for 1974 as of the close of 1976	2,000

(h) The taxes imposed on the trust attributable to the undistributed net income of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to $1,132 ($4,196 less $3,064).

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§ 1.666(d)–1A Information required from trusts.

(a) *Adequate records required.* For all taxable years of a trust, the trustee must retain copies of the trust's income tax return as well as information pertaining to any adjustments in the tax shown as due on the return. The trustee shall also keep the records of the trust required to be retained by section 6001 and the regulations thereunder for each taxable year as to which the period of limitations on assessment of tax under section 6501 has not expired. If the trustee fails to produce such copies and records, and such failure is due to circumstances beyond the reasonable control of the trustee or any predecessor trustee, the trustee may reconstruct the amount of corpus, accumulated income, etc., from competent sources (including, to the extent permissible, Internal Revenue Service records). To the extent that an accurate reconstruction can be made for a taxable year, the requirements of this paragraph shall be deemed satisfied for such year.

(b) *Rule when information is not available*—(1) *Accumulation distributions.* If adequate records (as required by paragraph (a) of this section) are not available to determine the proper application of subpart D to an accumulation distribution made in a taxable year by a trust, such accumulation distribution shall be deemed to consist of undistributed net income earned during the earliest preceding taxable year (as defined in § 1.665(e)–1A) of the trust in which it can be established that the trust was in existence. If adequate records are available for some years, but not for others, the accumulation distribution shall be allocated first to the earliest preceding taxable year of the trust for which there are adequate records and then to each subsequent preceding taxable year for which there are adequate records. To the extent that the distribution is not allocated in such manner to years for which adequate records are available, it will be deemed distributed on the last day of the earliest preceding taxable year of the trust in which it is established that the trust was in existence and for which the trust has no records. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust makes a distribution in 1975 of $100,000. The trustee has adequate records for 1973, 1974, and 1975. The records show that the trust is on the calendar year basis, had distributable net income in 1975 of $20,000, and undistributed net income in 1974 of $15,000, and in 1973 of $16,000. The trustee has no other records of the trust except for a copy of the trust instrument showing that the trust was established on January 1, 1965. He establishes that the loss of the records was due to circumstances beyond his control. Since the distribution is made in 1975, the earliest ''preceding taxable year'', as defined in § 1.665(e)–1A, is 1969. Since $80,000 of the distribution is an accumulation distribution, and $31,000 thereof is allocated to 1974 and 1973, $49,000 is deemed to have been distributed on the last day of 1969.

(2) *Taxes.* (i) If an amount is deemed under this paragraph to be undistributed net income allocated to a preceding taxable year for which adequate records are not available, there shall be deemed to be ''taxes imposed on the trust'' for such preceding taxable year an amount equal to the taxes that the trust would have paid if the deemed undistributed net income were the amount remaining when the taxes were subtracted from taxable income of the trust for such year. For example, assume that an accumulation distribution in 1975 of $100,000 is deemed to be undistributed net income from 1971, and that the taxable income required to produce $100,000 after taxes in 1971 would be $284,966. Therefore the amount deemed to be ''taxes imposed on the trust'' for such preceding taxable year is $184,966.

(ii) The credit allowed by section 667(b) shall not be allowed for any amount deemed under this subparagraph to be ''taxes imposed on the trust.''

[T.D. 7204, 37 FR 17146, Aug. 25, 1972]

§ 1.666(a)–1 Amount allocated.

(a)(1) If a trust other than a foreign trust created by a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years. It is therefore necessary to determine the extent to which there is undistributed net income for the preceding 5 years. For this purpose, an accumulation distribution made in any taxable year is allocated to each of the 5 preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(2) If a foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. It is therefore necessary to determine the extent to which there is undistributed net income for such preceding taxable years. For this purpose, an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(3) If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire

foreign trust. Accordingly, an accumulation distribution of such a trust is composed of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income for the applicable foreign trust for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the most recently accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. If the foreign trust created by a person other than a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years.

(b) If, before the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1960 and the trust had no undistributed net income for the taxable year 1959, then no portion of the 1960 accumulation distribution is deemed distributed on the last day of 1959. For purposes of subpart D, the term *5 preceding taxable years* includes only the 5 taxable years immediately preceding the taxable year in which the accumulation distribution is made and which are subject to part I (section 641 and following) of such subchapter J even though the trust has no undistributed net income during one or more of those years.

(c) Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. In 1964, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1963, the trust had $7,000 of undistributed net income; in 1962, none; in 1961, $12,000; in 1960, $4,000; in 1959, $4,000. The accumulation distribution is deemed distributed $7,000 in 1963, none in 1962, $12,000 in 1961, $4,000 in 1960, and $2,000 in 1959.

Example 2. In 1964, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of $50,000. In 1963, the trust had $12,000 of undistributed net income; in 1962, none; in 1961, $10,000; in 1960, $8,000; in 1959, $5,000; in 1958, $14,000; in 1957, none; in 1956, $3,000; in 1955, $2,000; and in 1954, $1,000. The accumulation distribution is deemed distributed $12,000 in 1963, none in 1962, $10,000 in 1961, $8,000 in 1960, $5,000 in 1959, $14,000 in 1958, none in 1957, $1,000 in 1956.

Example 3. A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1964, the trust makes an accumulation distribution of $150,000 to the U.S. beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of §1.643(d)–1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of §1.665(a)–1. For the taxable years 1952 through 1963, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1963	$20,000	$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	11,000	5,000
1954	None	None
1953	12,000	7,000
1952	7,000	4,000
Totals	120,000	60,000

The accumulation distribution in the amount of $150,000 is deemed to have been distributed in the amount of $100,000 (120,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a U.S. person, and in the amount of $50,000 (60,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1963	$20,000	$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	10,000	5,000
1954	None	None
1953	None	1,000
1952	None	None
Totals	100,000	50,000

Pursuant to paragraph (a)(3) of this section, the accumulation distribution in the amount of $100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's gross income for 1964, as this amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1964 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person only the undistributed net income for the years 1959 through 1963 which totals $39,000 is includible in the beneficiary's gross income for 1964. Thus, of the $150,000 distribution made in 1964, the beneficiary is required to include a total of $139,000 in his gross income for 1964.

Example 4. Assume the same facts as in example 3 and, in addition, that by December 31, 1964, the undistributed net income for 1964 is determined to be $20,000, and that in accordance with the provisions of paragraph (b)(3) of § 1.643(d)–1 and paragraph (b) of § 1.665(a)–1, $10,000 is allocated to the portion of the trust which is a foreign trust created by a U.S. person and $10,000 is allocated to the portion of the trust which is a foreign trust created by a person other than a U.S. person. On March 31, 1965, the trust makes an accumulation distribution of $25,000 to the U.S. beneficiary. For the taxable years 1952 through 1964, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1964	$10,000	$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None
1954	None	None
1953	12,000	6,000
1952	7,000	4,000
Totals	30,000	20,000

The accumulation distribution is deemed to have been distributed in the amount of $15,000 (30,000/50,000×$25,000), from the portion of the trust which is a foreign trust created by a U.S. person, and in the amount of $10,000 (20,000/50,000×$25,000) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1964	$10,000	$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None
1954	None	None

Year	Throwback to preceding years of foreign trust created by U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1953	4,000	None
1952	None	None
Totals	15,000	10,000

Pursuant to paragraph (a)(3) of this section, only $11,000 of the accumulation distribution in the amount of $15,000 from the portion of the trust which is a foreign trust created by a U.S. person is includible in the beneficiary's gross income for 1965 as the $11,000 amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $10,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1965 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, the entire $10,000 (representing the undistributed net income for the year 1964) is includible in the beneficiary's gross income for 1965. Thus, of the $25,000 distribution made in 1965, the beneficiary is required to include a total of $21,000 in his gross income for 1965.

(d) For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is computed without regard to the accumulation distribution of the taxable year or of taxable years following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. Accordingly, if a trust has undistributed net income for the taxable year 1954 and makes an accumulation distribution during the taxable year 1955, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1955 or any subsequent year. If the trust makes a further accumulation distribution for 1956, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1956 or subsequent years; but in determining the undistributed net income for 1954 for purposes of the 1956 accumulation distribution the accumulation distribution for 1955 will be taken into account.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 736, Jan. 17, 1969]

§ 1.666(b)–1 Total taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the ''taxes imposed on the trust'' (as defined in § 1.665(d)–1) for such preceding taxable year is likewise deemed distributed under section 661(a)(2). For example, a trust has taxable income of $11,032 (not including any capital gains) and undistributed net income of $8,000 for the taxable year 1954. The taxes imposed on the trust are $3,032. During the taxable year 1955, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under § 1.666(a)–1 to have been distributed on the last day of 1954. The taxes imposed on the trust for 1954 of $3,032 are also deemed to have been distributed on the last day of 1954 since the 1955 accumulation distribution is not less than the 1954 undistributed net income. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1954 because of the accumulation distribution of $8,000 made in 1955.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following such taxable year. However, any accumulation distribution of taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666(a)–1 and paragraphs (f)(5) and (g)(1) of § 1.668(b)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.666(c)–1 Pro rata portion of taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust, as defined in § 1.665(d)–1, for such preceding taxable year, multiplied by the fraction of which the numerator is the amount of the accumulation distribution and the denominator is the undistributed net income for such preceding taxable year. See paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in § 1.666(c)–2, and paragraph (f)(2) of § 1.668(b)–2 for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666(a)–1, paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.666(c)–2 and paragraph (f)(5)(iii) of § 1.668(b)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.666(c)–2 Illustration of the provisions of section 666.

The application of the provisions of §§ 1.666(a)–1, 1.666(b)–1, and 1.666(c)–1 may be illustrated by the following examples:

Example 1. (a) A trust makes accumulation distributions as follows:

1959	$7,000
1960	25,000

For 1954 through 1958, the undistributed portion of distributable net income taxes imposed on the trust, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust	Undistributed net income
1958	$12,100	$3,400	$8,700
1957	16,100	5,200	10,900
1956	6,100	1,360	4,740
1955	None	None	None
1954	10,100	2,640	7,460

(b) Since the entire amount of the accumulation distribution for 1959 ($7,000), determined without regard to the accumulation distribution for 1960, is less than the undistributed net income for 1958 ($8,700), an additional amount of $2,736 (7,000/ 8,700×$3,400) is likewise deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1960, the undistributed net income for 1958 will take into account the accumulation distribution for 1959, and the additional amount of taxes imposed on the trust for 1958 deemed distributed. The undistributed net income for 1958 will then be $1,906; and the taxes imposed on the trust for 1958 will then be $458, determined as follows:

Undistributed portion of distributable net income as of the close of 1958		$12,100
Less:		
Accumulation distribution (1959)	$7,000	
Taxes deemed distributed under section 666(c) (7,000/ 8,700×$3,400)	2,736	
		9,736
Balance (undistributed portion of distributable net income as of the close of 1959)		2,364
Less: Personal exemption		100
Balance		2,264
Taxes imposed on the trust (income taxes on $2,264)		458
Undistributed portion of distributable net income as of the close of 1959		2,364
Less: Income taxes attributable thereto		458
Undistributed net income for 1958 as of the close of 1959		1,906

(d) The accumulation distribution of $25,000 for 1960 is deemed to have been made on the last day of the 5 preceding taxable years of the trust to the extent of $17,546, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $7,018, the total taxes imposed on the trust for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1959	None	None
1958	$1,906	$458
1957	10,900	5,200
1956	4,740	1,360
1955	None	None

(e) No portion of the 1960 accumulation distribution is deemed made on the last day of 1954 because, as to 1960, 1954 is the sixth preceding taxable year.

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties.

Both X and the trust report on the calendar year basis. All of the income for 1954 was accumulated. The distributable net income of the trust for the taxable year 1954 is $20,100 and the income taxes paid by the trust for 1954 with respect to its distributable net income are $7,260. All of the income for 1955 and 1956 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of $6,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1954, is $12,840, computed as follows:

Distributable net income	$20,100
Less: Taxes imposed on the trust	7,260
Undistributed net income as of the close of 1954	12,840

(c) The accumulation distribution of $6,420 made during the taxable year 1955 is deemed under section 666(a) to have been made on December 31, 1954. Since this accumulation distribution is less than the 1954 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1954 is also deemed under section 666(c) to have been distributed on December 31, 1954. The total amount deemed to have been distributed to X on December 31, 1954, is $10,050, computed as follows:

Accumulation distribution	$6,420
Taxes deemed distributed (6,420/12,840×$7,260)	3,630
Total	10,050

(d) After the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to the accumulation distribution of 1955, the undistributed portion of the distributable net income of the trust for 1954, is $10,050, and the taxes imposed with respect thereto are $2,623, computed as follows:

Distributable net income as of the close of 1954	$20,100
Less: 1955 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (c) of this example)	10,050
Undistributed portion of the 1954 distributable net income adjusted as of the close of 1955	10,050
Less: Personal exemption	100
Balance	9,950
Income taxes on $9,950	2,623

(e) The undistributed net income of the trust for the taxable year 1954, as adjusted to give effect to the 1955 accumulation distribution, is $7,427, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10,050
Less: Income taxes applicable thereto	2,623
Undistributed net income determined as of the close of 1955	7,427

(f) Inasmuch as all of the income of the trust for the taxable year 1955 was distributed to X, the trust had no undistributed net income for that year. Accordingly, the accumulation distribution of $6,420 made during the taxable year 1956 is, under section 666(a), deemed a distribution to X on December 31, 1954, within the meaning of section 661(a)(2). Since this accumulation distribution is less than the 1954 adjusted undistributed net income of $7,427, the trust is deemed under section 666(c) also to have distributed on December 31, 1954, a portion of the taxes imposed on the trust for 1954. The total amount deemed to be distributed on December 31, 1954, with respect to the accumulation distribution made in 1956, is $8,687, computed as follows:

Accumulation distribution	$6,420
Taxes deemed distributed (6,420/7,427×$2,623)	2,267
Total	8,687

(g) After the application of the provisions of subpart D to the accumulation distribution of 1956, the undistributed portion of the distributable net income of the trust for 1954, is $1,363, and the taxes imposed on the trust with respect thereto are $253, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10,050
Less: 1956 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (f) of this example)	8,687
Undistributed portion of distributable net income as of the close of 1956	1,363
Less: Personal exemption	100
Balance	1,263
Income taxes on $1,263	253

(h) The undistributed net income of the trust for the taxable year 1954, determined as of the close of the taxable year 1956, is $1,110 ($1,363 less $253).

§ 1.667–1 Denial of refund to trusts.

(a) If an amount is deemed under section 666 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of ''taxes imposed on the trust'', as defined in § 1.665(d)–1, which would not have been payable for the preceding taxable year had the trust in fact made such distribution on the last day of such year. However, such taxes are allowed as a credit under section 668(b) against the tax of the beneficiaries who are treated as having received the distributions in the preceding taxable year. The amount of taxes which may not be refunded or credited to the trust under this paragraph and which are allowed as a credit under section 668(b) against the tax of the beneficiaries, is an amount equal to the excess of:

(1) The taxes imposed on the trust (as defined in section 665(d) and § 1.655(d)–1) for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over

(2) The amount of taxes for such preceding taxable year which would be imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, on account of the accumulation distribution determined for the taxable year.

It should be noted that the credit under section 667 is computed by the use of a different ratio from that used for computing the amount of taxes deemed distributed under section 666(c).

(b) Paragraph (a) of this section may be illustrated by the following examples:

Example 1. In 1954, a trust of which A is the sole beneficiary has taxable income of $20,000 (including capital gains of $5,100 allocable to corpus less a personal exemption of $100), on which a tax of $7,260 is paid.

The undistributed portion of distributable net income is $15,000, to which $6,160 of the tax is allocable under section 665. The undistributed net income is therefore $8,840 ($15,000 minus $6,160). In 1955, the trust makes an accumulation distribution of $8,840. Under section 666(b), the total taxes for 1954 attributable to the undistributed net income are deemed distributed, so $15,000 is deemed distributed. The amount of the tax which may not be refunded to the trust under section 667 and the credit to which A is entitled under section 668(b) is the excess of $6,160 over zero, since after the distribution and the application of subpart D there is no remaining undistributed portion of distributable net income for 1954.

Example 2. The same trust as in example 1 of this paragraph distributes $5,000 in 1955, rather than $8,840. The amount of the tax which may not be refunded to the trust but which is available to A as a credit is $4,044, computed as follows:

Accumulation distribution in 1955		$5,000
Taxes deemed distributed under section 666(c) (5,000/8,840×$6,160)		3,484
Total amount deemed distributed out of the undistributed portion of distributable net income		8,484
Tax attributable to the undistributed portion of distributable net income ($15,000) before 1955 distribution (see example 1 of this paragraph)		6,160
Tax on $11,516 (taxable income of $20,000 minus $8,484, amount deemed distributed)	$3,216	
Tax on $5,000 (capital gains of $5,100, less personal exemption of $100, allocable to corpus)	1,100	
Tax attributable to undistributed portion of distributable net income after 1955 distribution		2,116
Refund disallowed to the trust and credit available to A in 1955		4,044

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.667(a)–1A Denial of refund to trusts.

If an amount is deemed under section 666 or 669 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of ''taxes imposed on the trust'', as defined in § 1.665(d)–1A. However, such taxes imposed on the trust are allowed as a credit under section 667(b) against the tax of certain beneficiaries who are treated as having received the distributions in the preceding taxable year.

[T.D. 7204, 37 FR 17147, Aug. 25, 1972]

§ 1.667(b)–1A Authorization of credit to beneficiary for taxes imposed on the trust.

(a) *Determination of credit*—(1) *In general.* Section 667(b) allows under certain circumstances a credit (without interest) against the tax imposed by subtitle A of the Code on the beneficiary for the taxable year in which the accumulation distribution is required to be included in income under section 668(a). In the case of an accumulation distribution consisting only of undistributed net income, the amount of such credit is the total of the taxes deemed distributed to such beneficiary under section 666 (b) and (c) as a result of such accumulation distribution for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.668(b)–1A. In the case of an accumulation distribution consisting only of undistributed capital gain, the amount of such credit is the total of the taxes deemed distributed as a result of the accumulation distribution to such beneficiary under section 669 (d) and (e) for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.669(b)–1A. In the case of an accumulation distribution consisting of both undistributed net income and undistributed capital gain, a credit will not be available unless the total taxes deemed distributed to the beneficiary for all preceding taxable years as a result of the accumulation distribution exceeds the beneficiary's partial tax determined under §§ 1.668(b)–1A and 1.669(b)–1A without reference to the taxes deemed distributed. A credit is not allowed for any taxes deemed distributed as a result of an accumulation distribution to a beneficiary by reason of sections 666 (b) and (c) or sections 669 (d) and (e) for a preceding taxable year of the trust before the beneficiary was born or created. However, if as a result of an accumulation distribution the total taxes deemed distributed under sections 668(a)(2) and 668(a)(3) in preceding taxable years before the beneficiary was born or created exceed the partial taxes attributable to amounts deemed distributed in such years, such excess may be used to offset any liability for partial taxes attributable to amounts deemed distributed as a result of the same accumulation distribution in preceding taxable years after the beneficiary was born or created.

(2) *Exact method.* In the case of the tax computed under the exact method provided in §§ 1.668(b)–1A(b) and 1.669(b)–1A(b), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed under §§ 1.666(b)–1A and 1.666(c)–1A or §§ 1.669(d)–1A and 1.669(e)–1A, whichever are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(ii) Compute the total of the amounts of tax determined under § 1.668(b)–1A(b)(1) or § 1.669(b)–1A(b) (1), whichever is appropriate, for the prior taxable years of the beneficiary in which he was in being.

If the amount determined under subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable. If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph, the credit allowable is the lesser of the amount of such excess or the amount of taxes deemed distributed to the beneficiary for all preceding taxable years to the extent that such taxes are not used in § 1.668(b)–1A(b)(2) or § 1.669(b)–1A(b)(2) in determining the beneficiary's partial tax under section 668(a)(2) or 668(a)(3). The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution made in 1975 is deemed distribution in 1973 and 1974, years in which the beneficiary was in being. The taxes deemed distributed in such years are $4,000 and $2,000, respectively, totaling $6,000. The amounts of tax computed under § 1.668(b)–1A(b)(1) attributable to the amounts thrown back are $3,000 and $2,000, respectively, totaling $5,000. The credit allowable under this subparagraph is therefore $1,000 ($6,000 less $5,000).

(3) *Short-cut method.* In the case of the tax computed under the short-cut method provided in § 1.668(b)–1A(c) or § 1.669(b)–1A(c), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed in all preceding taxable years of the trust under §§ 1.666(b)–1A and 1.666(c)–1A or §§ 1.669(d)–1A and 1.669(e)–1A, whichever are appropriate.

(ii) Compute the beneficiary's partial tax determined under either § 1.668(b)–

1A(c)(1)(v) or § 1.669(b)–1A (c)(1)(v), whichever is appropriate.

If the amount determined under subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable. If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph,

(iii) Compute the total taxes deemed distributed under §§ 1.666(b)–1A and 1.666(c)–1A or §§ 1.669(d)–1A and 1.669(e)–1A, which are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(iv) Multiply the amount by which subdivision (i) of this subparagraph exceeds subdivision (ii) of this subparagraph by a fraction, the numerator of which is the amount determined under subdivision (iii) of this subparagraph and the denominator of which is the amount determined under subdivision (i) of this subparagraph. The result is the allowable credit. The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution that consists only of undistributed net income is made in 1975. The taxes deemed distributed in the preceding years under §§ 1.666(b)–1A and 1.666(c)–1A are $15,000. The amount determined under § 1.668(b)–1A(c)(1)(v) is $12,000. The beneficiary was in being on the last day of all but one preceding taxable year in which the accumulation distribution was deemed made, and the taxes deemed distributed in those years was $10,000. Therefore, the excess of the subdivision (i) amount over the subdivision (ii) amount is $3,000, and is multiplied by 10,000/15,000, resulting in an answer of $2,000, which is the credit allowable when computed under the short-cut method.

(b) *Year of credit.* The credit to which a beneficiary is entitled under this section is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the income of the beneficiary under section 668(a). Any excess over the total tax liability of the beneficiary for such year is treated as an overpayment of tax by the beneficiary. See section 6401(b) and the regulations thereunder.

[T.D. 7204, 37 FR 17147, Aug. 25, 1972]

§ 1.668(a)–1A Amounts treated as received in prior taxable years; inclusion in gross income.

(a) Section 668(a) provides that the total of the amounts treated under sections 666 and 669 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the income of the beneficiary or beneficiaries receiving them. The total of such amounts is includable in the income of each beneficiary to the extent the amounts would have been included under section 662 (a)(2) and (b) as if the total had actually been an amount properly paid by the trust under section 661 (a)(2) on the last day of such preceding taxable year. The total is included in the income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder.

(b) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

(c) For purposes of applying section 668(a)(3), a trust shall be considered to be other than a ''trust which is not required to distribute all of its income currently'' for each taxable year prior to the first taxable year beginning after December 31, 1968, and ending after November 30, 1969, in which income is accumulated. Income will not be deemed to have been accumulated for purposes of applying section 668(a)(3) in a year if the trustee makes a determination, as evidenced by a statement on the return, to distribute all of the trust's income for such year and also makes a good faith determination as to the amount of such income and actually distributed for such year the entire amount so determined. The term ''income,'' as used in the preceding two sentences, is defined in §§ 1.643(b)–1 and 1.643(b)–2. Since, under such definitions, certain items may be included in distributable net income but are not, under applicable local law, ''income'' (as, for example, certain extraordinary dividends), a trust that has undistributed net income from such sources might still qualify as a trust that has not accumulated income. Also, for example, if a trust establishes a reserve for depreciation or depletion and applicable local law permits the deduction for such reserve in the computation of ''income,'' amounts so added to the reserve do not constitute an accumulation of income. If a trust has separate shares, and any share accumulates income, all shares of the trust will be considered to have accumulated income for purposes of section 668(a)(3). Amounts retained by a trust or a portion of a trust that is subject to subpart E (sections 671–678) shall not be considered accumulated income.

(d) See section 1302(a)(2)(B) to the effect that amounts included in the income of a beneficiary of a trust under section 668(a) are not eligible for income averaging.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§ 1.668(a)–2A Allocation among beneficiaries; in general.

The portion of the total amount includible in income under § 1.668(a)–1A which is includible in the income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for taxable year 1975 is $10,000. The trust had undistributed net income for taxable year 1973, the first year of the trust, of $5,000, to which a tax of $1,100 was allocable. On May 1, 1975, the trustee distributes $10,000 to A, and on November 29, 1975, he distributes $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B receives one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1975, the trust is deemed to have made the following distributions:

Amount distributed out of 1975 income (distributable net income)	$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1973 under section 666(a)	5,000
Taxes imposed on the trust attributable to the undistributed net income deemed distributed under section 666(b)	1,100

(c) A will include in his income for 1975 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income $6,666.67 (10,000/15,000× $10,000) of the 1975 distributable net income of the trust as provided in section 662(a)(2) (which is not an amount includable in his income under § 1.668(a)–1A(a)). He will include in his income $3,333.33 (10,000/15,000×$5,000) of the accumulation distribution and $733.33 (10,000/15,000× $1,100) of the taxes imposed on the trust, as provided in section 668(a).

(d) B will include in his income for 1975 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

(e) To the extent the total accumulation distribution consists of undistributed net income and undistributed capital gain, A and B shall be treated as receiving a pro rata share of each for the preceding taxable year 1973.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§ 1.668(a)–3A Determination of tax.

In a taxable year in which an amount is included in a beneficiary's income under § 1.668(a)–1A(a), the tax on the beneficiary for such taxable year is determined only as provided in section 668 and consists of the sum of:

(a) A partial tax computed on (1) the beneficiary's taxable income reduced by (2) an amount equal to the total amounts includible in his income under § 1.668(a)–1A(a), at the rate and in the manner as if section 668 had not been enacted,

(b) A partial tax determined as provided in § 1.668(b)–1A, and

(c) In the case of a beneficiary of a trust which is not required to distribute all of its income currently, a partial tax determined as provided in § 1.669(b)–1A.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§ 1.668(b)–1A Tax on distribution.

(a) *In general.* The partial tax imposed on the beneficiary by section 668(a)(2) shall be the lesser of:

(1) The tax computed under paragraph (b) of this section (the ''exact'' method), or

(2) The tax computed under paragraph (c) of this section (the ''short-cut'' method),

except as provided in § 1.668(b)–4A (relating to failure to furnish proper information) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary's choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(3).

(b) *Computation of partial tax by the exact method.* The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years. For purposes of this paragraph, the ''section 666 amounts'' for a preceding taxable year are the amounts deemed distributed under section 666(a) on the last day of the preceding taxable year, plus the amount of taxes deemed distributed on such day under section 666 (b) or (c). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 666 amounts in the beneficiary's gross income and the tax for such year computed without including them in such gross income. Tax computations for each such year shall reflect a taxpayer's marital, dependency, exemption, and filing status for such year. To the extent the undistributed net income of a trust deemed distributed in an accumulation distribution includes amounts received as an accumulation distribution from another trust, for purposes of this paragraph they shall be considered as amounts deemed distributed by the trust under section 666(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income and taxes of trust Y for the taxable years 1972, 1973, and 1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income and taxes, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)–1A and 1.666(c)–1A as does not exceed such sum. The resulting amount, if any, is the partial tax, computed under the exact method, for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to the beneficiary.

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

Example. (i) Assume that in 1979 a trust makes an accumulation distribution of $15,000 to A. The accumulation distribution is allocated under section 666(a) in the amounts of $5,000 to 1971, $4,000 to 1972, and $6,000 to 1973. Under section 666 (b) and (c), taxes in the amounts of $935, $715, and $1,155 (totaling $2,805) are deemed distributed in 1971, 1972, and 1973, respectively.

(ii) A, the beneficiary, had taxable income and paid income tax in 1971–73 as follows:

Year	Taxable income	Tax
1971	$10,000	$2,190
1972	12,000	2,830
1973	14,000	3,550

(iii) Taxes attributable to the section 666 amounts (paragraph (i) of this example) are $6,979, computed as follows:

1971

Taxable income including section 666 amounts ($10,000 + $5,000 + $935)	$15,935	
Tax on $15,935		$4,305
Less: Tax paid by A in 1971		2,190

Tax attributable to 1971 section 666 amounts		2,115
1972		
Taxable income including section 666 amounts ($12,000 + $4,000 + $715)	$16,715	
Tax on $16,715		$4,620
Less: Tax paid by A in 1972		2,830
Tax attributable to 1972 section 666 amounts		1,790
1973		
Taxable income including section 666 amounts ($14,000 + $6,000 + $1,155)	$21,155	
Tax on $21,155		$6,624
Less: Tax paid by A in 1973		3,550
Tax attributable to 1973 section 666 amounts		3,074
Total tax attributable to section 666 amounts:		
1971	$2,115	
1972	1,790	
1973	3,074	
Total	6,979	

(iv) The partial tax computed under the exact method is $4,174, computed by subtracting the taxes deemed distributed ($2,805) from the tax attributable to the section 666 amounts ($6,979).

(c) *Computation of tax by the short- cut method.* (1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received an accumulation distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such accumulation distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income of trust Y for the taxable years 1972, 1973, and 1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed net income deemed distributed is less than 25 percent of *(a)* the total amounts deemed under section 666(a) to be undistributed net income from preceding taxable years divided by *(b)* the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed without application of this sentence. For example, assume that an accumulation distribution of $90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of $29,000 in each of the years 1972, 1973, and 1974, and $3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is four. However, the distribution deemed made in 1975 ($3,000) is less than $5,625, which is 25 percent of *(a)* the total undistributed net income deemed distributed under section 666(a) ($90,000) divided by *(b)* the number of such preceding taxable years (4), or $22,500. Therefore, for purposes of this subparagraph the accumulation distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the accumulation distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subdivision (i) of this subparagraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of each class of income as the total of each class of income deemed distributed in the accumulation distribution bears to the total undistributed net income from such preceding taxable years deemed distributed in the accumulation distribution. For example, assume that an amount of $50,000 is deemed distributed under section 666(a) from undistributed net income of 5 preceding taxable years of the trust, and consists of $25,000 of interest, $15,000 of dividends, and

$10,000 of net rental income. Taxes attributable to such amounts in the amount of $10,000 are also deemed distributed. The amount determined under this subdivision, $12,000 ($50,000 income plus $10,000 tax divided by 5 years), is deemed to consist of $6,000 in interest, $3,600 in dividends, and $2,400 in net rental income.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.

The difference between the amount of tax computed under *(a)* of this subdivision for each year and the amount computed under *(b)* of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph. For example, assume that a distribution of $12,000, is includible in the income of each of the beneficiary's 3 preceding taxable years when his income (without the inclusion of the accumulation distribution) was $20,000, $30,000, and $40,000. The inclusion of $12,000 in income would produce taxable income of $32,000, $42,000, and $52,000, and the tax attributable to such increases would be $4,000, $5,000, and $6,000, respectively.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3. For example, if these additional taxes are $4,000, $5,000, and $6,000 for the 3 preceding taxable years, this amount would be $5,000 ($4,000+$5,000+ $6,000 divided by 3).

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subdivision (i) of this subparagraph). For example, if an amount is deemed distributed for 5 preceding taxable years, the resulting amount would be five times the $5,000 amount.

(vi) Sixth, the resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)–1A and 1.666(c)–1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 668(b)(1)(B).

(2) The computation of the tax by the short-cut method may be illustrated by the following example:

Example: In 1971, X creates a trust which is to accumulate its income and pay the income to Y when Y reaches 30. Y is 19. Over the 11 years of the trust, the trust earns $1,200 of interest income annually and has expenses each year of $100 allocable to the production of income. The trust pays a total tax of $1,450 on the accumulated income. In 1981, when Y reaches 30, the $9,550 of accumulated undistributed net income and the $1,100 of current net income are distributed to Y. Y is treated as having received a total distribution of $11,000 (the $9,550 accumulation distribution plus the taxes paid by the trust which are deemed to have been distributed to Y). The income of the current year (1981) is taxed directly to Y. The computation is as follows: $11,000 (accumulation distribution plus taxes) divided by 10 (number of years out of which distribution was made) equals $1,100. The $1,100 added to the income of the beneficiary's preceding 3 years produces increases in tax as follows:

1980	$350
1979	300
1978	250
Total	900

$900 (total additional tax) divided by 3 equals $300 (average annual increase in tax). $300 (average annual increase in tax) times 10 equals $3,000, from which is deducted the amount of taxes ($1,450) paid by the trust attributable to the undistributed net income deemed distributed. The amount of tax to be paid currently under the short-cut method is therefore $1,550.

(d) *Disallowance of short-cut method.* If, in any prior taxable year of the beneficiary in which any part of the accumulation distribution of undistributed net income is deemed to have been distributed under section 666(a) to such beneficiary, any part of prior accumulation distributions of undistributed net income by each of two or more other trusts is deemed under section 666(a) to have been distributed to such beneficiary, then the short-cut method under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(2) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes an accumulation distribution of undistributed net income to A, who is on the calendar year basis, and part of the accumulation distribution is deemed under section 666(a) to have been distributed on March 31, 1974. In 1977, A had received an accumulation distribution of undistributed net income from both trust Y and trust Z. Part of the accumulation distribution from trust Y was deemed under section 666(a) to have been distributed to A on June 30, 1974, and part of the accumulation distribution from trust Z was deemed under section 666(a) to have been distributed to A on December 31, 1974. Because there were portions of accumulation distributions of undistributed net income from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 accumulation distribution from trust X may not be computed under the shortcut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 666(a)(2).

[T.D. 7204, 37 FR 17149, Aug. 25, 1972]

§ 1.668(b)–2A Special rules applicable to section 668.

(a) *Rule when beneficiary not in existence on the last day of a taxable year.* If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of § 1.668(b)–1A, that the beneficiary:

(1) Was in existence on such last day,

(2) Was a calendar year taxpayer,

(3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,

(4) If an individual, was unmarried and had no dependents,

(5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and

(6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of an accumulation distribution made in 1980 is deemed under section 666(a) to have been distributed to the beneficiary, A, in 1973; $10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of § 1.668(b)–1A that A was alive in 1973, was on the calendar year basis, had no income other than (i) the $10,000 from the earlier accumulation distribution deemed distributed in 1973, and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. It should be noted that the standard deduction for 1973 will be available to A with respect to the distribution only to the extent it qualifies as ''earned income'' in the hands of the trust. See section 141(e) and the regulations thereunder and § 1.652(b)–1. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A's first actual taxable year.

(b) *Effect of other distributions.* The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under § 1.668(b)–1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a ''prior accumulation distribution'' is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term ''prior accumulation distribution'' also includes accumulation distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (c) of this section to treat as having been distributed before the accumulation distribution for which tax is being computed under §1.668(b)–1A. Any capital gain distribution from the same trust paid, credited, or required to be distributed in the same taxable year of the beneficiary shall not be considered under this paragraph to be a ''prior capital gain distribution.''

(c) *Multiple distributions in the same taxable year.* For purposes of paragraph (b) of this section, accumulation distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several accumulation distributions. The beneficiary shall indicate the order he has determined to deem the accumulation distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(d) *Examples.* The provisions of paragraphs (b) and (c) of this section may be illustrated by the following examples:

Example 1. In 1978, trust X made an accumulation distribution of undistributed net income to A, a calendar year taxpayer, of which $3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another accumulation distribution of undistributed net income to A, $10,000 of which is deemed under section 666 to have been distributed in 1974. Also in 1980, trust Y makes an accumulation distribution of undistributed net income to A, of which $5,000 is deemed under section 666 to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A's gross income for 1974 includes (i) the $3,000 deemed distributed from the 1978 distribution, and (ii) the $5,000 deemed distributed in 1974 from the 1980 trust Y accumulation distribution. To compute A's tax under the exact method for 1974 on the $10,000 from the 1980 trust X accumulation distribution deemed distributed in 1974, A's gross income for 1974 includes (i) the $10,000, (ii) the $3,000 previously deemed distributed in 1974 from the 1978 trust X accumulation distribution, and (iii) the $5,000 deemed distribution in 1974 from the 1980 trust Y accumulation distribution.

Example 2. In 1978, trust T makes an accumulation distribution of undistributed net income to B, a calendar year taxpayer. Determination of the tax on the accumulation distribution under the short-cut method requires the use of B's gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution of undistributed net income from trust U, of which $2,000 was deemed to have been distributed in 1975, and $3,000 in 1976. B's gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T accumulation distribution, will be deemed to include the $2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the $3,000 deemed distributed by trust U in 1976.

[T.D. 7204, 37 FR 17151, Aug. 25, 1972]

§ 1.668(b)–3A Computation of the beneficiary's income and tax for a prior taxable year.

(a) *Basis for computation.* (1) The beneficiary's income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under §1.668(b)–4A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for computation purposes. The term ''as finally determined'' has reference to the final status of the gross income, deductions, credits, and taxes of the taxable year after the expiration of the period of limitations or after completion of any court action regarding the tax for the taxable year.

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of

limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 666 amount in the beneficiary's gross income and the tax for such year computed without including such amounts in such gross income shall be based upon the return after the correction of such mathematical errors, and the beneficiary shall be credited for the correct amount of tax that should have been properly paid.

(b) *Effect of allocation of undistributed net income on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover.* (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed net income allocated to such year. For example, if $1,000 of undistributed net income is allocated to 1970, adjusted gross income for 1970 is increased from $5,000 to $6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed net income deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed net income on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by such amounts so allocated. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1978, a trust makes an accumulation distribution of undistributed net income to X of $50,000 that is deemed under section 666(a) to have been distributed in 1972. X had income in 1972, 1973, and 1973, and had a net operating loss in 1975 that offset his taxable income (computed as provided in § 1.172–5) for those years, as follows:

Year	Actual income (or loss)	Income after net operating loss carryback (n.o.l.c.b.)
1972	$10,000	$0
1973	50,000	0
1974	50,000	10,000
1975	(100,000)	0

As a result of the allocation of the 1973 accumulation distribution to 1972, X's income for 1972, 1973, 1974, and 1975, after taking into account the 1975 n.o.l.c.b., is deemed to be as follows:

Year	Income deemed to have been earned after consideration of n.o.l.c.b., and accumulation distribution
1972	0 ($10,000+$50,000 − $60,000 n.o.l.c.b.).
1973	$10,000 ($50,000 − $40,000 balance of n.o.l.c.b.).
1974	$50,000.
1975	0.

Therefore, the tax on the 1978 accumulation distribution to X is the tax X would have paid in 1973 and 1974 had he had the above income in such years.

(c) *Averaging.* A beneficiary who uses the exact method may recompute his tax for a prior taxable year by using income averaging for all of his actual income for that year, plus the amount deemed distributed in that year under section 666, even though he may not have actually used section 1301 to determine his income tax for such taxable year. For purposes of such recomputation, the beneficiary's income for all other taxable years involved must include any amounts deemed distributed in such years from the current and all prior accumulation distributions. See § 1.668(b)–4A(c)(3) for additional information requirements. The beneficiary may not apply the provisions of this paragraph to a taxable year in which an amount is deemed to be income by reason of § 1.666(d)–1A(b). The accumulation distribution itself is not eligible for income averaging in the years in which it is paid, credited, or required to be distributed. See section 1302 (a)(2)(B) and the regulations thereunder.

[T.D. 7204, 37 FR 17151, Aug. 25, 1972]

§ 1.668(b)–4A Information requirements with respect to beneficiary.

(a) *Information to be supplied by beneficiary*—(1) *In general.* The beneficiary must supply the information required by subparagraph (3) of this paragraph for any prior taxable year for which a recomputation is required under either the exact method or the short-cut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(2) is imposed.

(2) *Failure to furnish.* If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and the tax computed under paragraph (c) of § 1.668(b)–1A (the short-cut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(2). See, however, paragraph (b) of this section for an exception to this rule where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(3) *Information required.* The beneficiary shall file the following items with his income tax return for the taxable year in which the accumulation distribution is included in income:

(i) A statement showing the gross income, adjustments, deductions, credits, taxes paid, and computations for each of his taxable years for which a computation is required under the method by which he computes his partial tax imposed by section 668(a)(2). Such statement shall include such amounts for the taxable year as adjusted by any events subsequent to such year, such as any adjustment resulting from the determination of a deficiency or an overpayment, or from a court action regarding the tax.

(ii) A copy of the statement required by this subparagraph to be furnished by the beneficiary for any prior taxable year in which an accumulation distribution was received by him which was also deemed distributed in whole or in part in the prior taxable year for which the statement under subdivision (i) of this subparagraph is required.

(iii) A copy of any statements furnished the beneficiary by the trustee (such as schedules E and J of Form 1041, etc.) with regard to the current taxable year or any prior taxable year for which a statement is furnished under subdivision (i) of this subparagraph.

(b) *Exception.* If by reason of § 1.668(b)–1A(e) the beneficiary may not compute the partial tax on the accumulation distribution under § 1.668(b)–1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by subparagraph (3) of paragraph (a) of this section for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

(c) *Records to be supplied by the beneficiary*—(1) *Year when return was filed.* If the beneficiary filed an income tax return for a taxable year for which a recomputation is necessary, and the period of limitations on assessment under section 6501 for such year has expired as of the filing of the return for the year in which the accumulation distribution was made, then a copy of such return, plus proof of any changes of liability for such year due to the determination of a deficiency or an overpayment, court action, etc., shall, to the extent they verify the statements required under paragraph (a) of this section, serve as proof of such statements. If the period of limitations on assessment under section 6501 for a prior taxable year has not expired as of the filing of the beneficiary's return for the year in which the accumulation distribution was received, then the records required by section 6001 to be retained by the beneficiary for such prior taxable year shall serve as the basis of proof of the statements required to be filed under paragraph (a) of this section.

(2) *Year for which no return was filed.* If the beneficiary did not file a return for a taxable year for which a recomputation is necessary, he shall be deemed to have had in such year, in the absence of proof to the contrary, gross income in the amount equal to the maximum amount of gross income that he could have received without having had to file a return under section 6012 for such year.

(3) *Distributions deemed averaged.* In order for a beneficiary to use income averaging with respect to a prior taxable year (see § 1.668(b)–3A(c)), he must furnish all the information that would support the computation under section 1301 as if the distribution were actually received and averaged in such prior taxable year, even if a portion of the information relates to years in which no amount was deemed distributed to the beneficiary.

[T.D. 7204, 37 FR 17152, Aug. 25, 1972]

§ 1.668(a)–1 Amounts treated as received in prior taxable years; inclusion in gross income.

(a) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the gross income of the beneficiary or beneficiaries receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amounts would have been included under section 662 (a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder. See paragraphs (h)(1)(ii) and (j)(1)(ii) of § 1.668(b)–2.

(b) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in paragraph (a) of this section in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(c) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

§ 1.668(a)–2 Allocation among beneficiaries; in general.

The portion of the total amount includible in gross income under § 1.668 (a)–1 which is includible in the gross income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for the taxable year 1955 is $10,000. The trust had undistributed net income for the taxable year 1954 of $5,000, to which a tax of $1,100 was allocable. During the taxable year 1955, the trustee distributes $10,000 to A and $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B received one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1955, the trust is deemed to have made the following distributions:

Amount distributed out of 1955 income (distributable net income)	$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1954 under section 666(a)	5,000
Taxes imposed on the trust deemed distributed under section 666(b)	1,100

(c) A will include in his gross income for 1955 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income $6,666.67 (10,000/ 15,000×$10,000) of the 1955 distributable net income of the trust as provided in section 662(a)(2), and $3,333.33 (10,000/ 15,000×$5,000) of the accumulation distribution and $733.33 (10,000/15,000×$1,100) of the taxes imposed on the trust as provided in section 668(a).

(d) B will include in his gross income for 1955 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

§ 1.668(a)–3 Excluded amounts.

When a trust pays, credits, or is required to distribute to a beneficiary amounts which are excluded under section 665(b) (1), (2), (3), or (4) from the computation of an accumulation distribution, the amount includible under subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, in the gross income of the beneficiaries pursuant to § 1.668(a)–1 is first allocated to the beneficiaries as provided in § 1.668(a)–2 and, second, the amount allocable to the beneficiary receiving amounts which are excluded under section 665(b) (1), (2), (3), or (4) is reduced by the excluded amounts. This section may be illustrated by the following examples, in which it is assumed the trusts and beneficiaries report on the calendar year basis and the income of the trusts was derived entirely from taxable interest:

Example 1. (a) A trust in 1957 has income as defined in section 643(b) of $35,000 and expenses allocable to corpus of $5,000. Its distributable net income is, therefore, $30,000 ($35,000 − $5,000). The undistributed net income of the trust and the taxes imposed on the trust were $12,840 and $7,260, respectively, for each of the years 1956, 1955, and 1954. The terms of the trust instrument provide for the accumulation of income during the minority of beneficiaries A and B. However, the trustee may make discretionary distributions to either beneficiary after he becomes 21 years of age. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on January 1, 1957, and, as of that date, A was 25 years old. The trustee distributed $50,000 each to A and B during 1957.

(b) Since each beneficiary received one-half of the total amount distributed by the trust, each must include in gross income under section 662(a)(2) one-half ($15,000) of the distributable net income ($30,000) of the trust for 1957.

(c) The excess distribution of $35,000 ($50,000 − $15,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in B's gross income under section 668(a). Nor is such amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income under section 668(a).

(d) The accumulation distribution of the trust is $35,000, computed as follows:

Total distribution by the trust	....	$100,000
Less:		
Distributable net income for 1957	$30,000	
Excess distribution to B	35,000	
		65,000
Accumulation distribution to A		35,000

(e) The accumulation distribution of $35,000 will be allocated to the preceding taxable years 1956, 1955, and 1954, and the trust will be deemed to have made the following distributions to A on the last day of those years:

	1956	1955	1954	Total
Undistributed net income	$12,840	$12,840	$9,320	$35,000
Taxes imposed on the trust	7,260	7,260	5,270	19,790
Total	20,100	20,100	14,590	54,790

Thus, A will include $54,790 in his gross income for 1957 under section 668(a). A will, however, receive credit against his tax under section 668(b).

Example 2. (a) Under the terms of a trust the trustee may make discretionary distributions out of income to A during her life. The balance of the income is to be accumulated during the minority of her son, B, and is to be distributed to him when he becomes 21 years of age. Thereafter the trustee may also make discretionary payments of income to B. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on December 31, 1955. The distributable net income of the trust for 1955 is $30,000. It had undistributed net income of $12,840 for the preceding taxable year 1954 and the taxes imposed on the trust for such year were $7,260. The trustee distributed $15,000 to A during 1955 and on December 31, 1955, he distributed $60,000 to B, which represented income accumulated during his minority.

(b) Since B received four-fifths of the total amount ($75,000) distributed by the trust during 1955, he must include in his gross income under section 662(a)(2) four-fifths ($24,000) of the distributable net income ($30,000) of the trust for 1955. A will include in her gross income under section 662(a)(2) one-fifth ($6,000) of the distributable net income ($30,000) of the trust for 1955.

(c) The excess distribution of $36,000 ($60,000 − $24,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in his gross income under section 668(a).

(d) The amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income for 1955 under section 668(a) is $9,000, computed as follows:

Total distribution by the trust		$75,000
Less:		
Distributable net income for 1955	$30,000	
Excess distribution to B	36,000	
		66,000
Amount treated as an accumulation distribution		9,000

(e) Inasmuch as the amount of $9,000 is less than the total undistributed net income of the trust ($12,840) for the preceding taxable year 1954, a pro rata portion of the taxes imposed on the trust for that year are also deemed distributed by the trust. Thus, A will include $14,089 in her gross income for 1955 under section 668 (a) computed as follows:

1954	
Accumulation distribution	$9,000
Taxes imposed on the trust (9,000/12,840×$7,260)	5,089
Total	14,089

A will, however, receive credit against her tax under section 668(b).

§ 1.668(a)–4 Tax attributable to throwback.

(a) The tax attributable to amounts deemed distributed under section 666 is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made unless the taxable year of the beneficiary is different from that of the trust (see section 662(c) and the regulations thereunder). In the case of a trust (other than a foreign trust created by a U.S. person), the tax cannot be greater than the aggregate of the taxes attributable to those amounts had they been included, in accordance with the provisions of section 662 (a)(2) and (b), in the gross income of the beneficiary for the preceding taxable year or years in which they were deemed distributed. In the case of a foreign trust created by a U.S. person, the tax on the beneficiary shall be computed in accordance with the provisions of section 669 and the regulations thereunder. The tax liability of the beneficiary of a trust (other than a foreign trust created by a U.S. person), including the portion of an entire foreign trust which does not constitute a foreign trust created by a U.S. person (see § 1.643(d)–1), for the taxable year is computed in the following manner:

(1) First, compute the amount of tax for the taxable year attributable to the section 666 amounts which are included in the gross income of the beneficiary for the year. The tax attributable to those amounts is the difference between the tax for the taxable year computed with the inclusion of the section 666 amounts in gross income and the tax computed without including them in gross income.

(2) Next, compute the tax attributable to the section 666 amounts for each of the preceding taxable years as if they had been included in gross income for those years. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding year computed with the inclusion of the section 666 amounts in gross income and the tax for such year computed without including them in gross income. The tax computation for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(3) The total tax for the taxable year is the tax for that year computed without including the section 666 amounts, *plus:*

(i) The amount of the tax for the taxable year attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), or (ii) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (2) of this paragraph),

whichever is the smaller.

(b) The provisions of paragraph (a) of this section may be illustrated by the following example:

Example. (1) During the taxable year 1956, $10,000 is deemed distributed under section 666 to a beneficiary, of which $6,000 is deemed distributed by the trust on the last day of

1955 and $4,000 on the last day of 1954. The beneficiary had taxable income (after deductions) from other sources of $5,000 for 1956, $10,000 for 1955, and $10,000 for 1954. The beneficiary's tax liability for 1956 is $4,730 determined as follows:

Year 1956	
Tax on $15,000 (taxable income including section 666 amounts)	$4,730
Tax on $5,000 (taxable income excluding section 666 amounts)	1,100
Tax attributable to section 666 amounts	3,630
Year 1955	
Tax on $16,000 (taxable income including section 666 amounts)	$5,200
Tax on $10,000 (taxable income excluding section 666 amounts)	2,640
Tax attributable to section 666 amounts	2,560
Year 1954	
Tax on $14,000 (taxable income including section 666 amounts)	$4,260
Tax on $10,000 (taxable income excluding section 666 amounts)	2,640
Tax attributable to section 666 amounts	1,620

(2) Inasmuch as the tax of $3,630 attributable to the section 666 amounts as computed at 1956 rates is less than the aggregate of the taxes of $4,180 ($2,560 plus $1,620) determined for the preceding taxable years the amount of $3,630 is added to the tax ($1,100) computed for 1956 without including the section 666 amounts.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 737, Jan. 17, 1969]

§ 1.668(b)–1 Credit for taxes paid by the trust.

(a) The taxes imposed on a complex trust for a taxable year which would not have been payable by the trust if amounts deemed under section 666 to have been distributed in the year had in fact been distributed in the year are not allowable as a refund to the trust but are allowable as a credit against the tax of the beneficiaries to whom the amounts described in section 666(a) are distributed.

(b) The credit to which a beneficiary is entitled under section 668(b) is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the gross income of the beneficiary. Any excess over the total tax liability of the beneficiary is treated as an overpayment of tax by the beneficiary.

(c) The beneficiary is entitled to a portion of the credit described in paragraph (a) of this section in the ratio which the amount of the accumulation distribution to him bears to the accumulation distributions to all the beneficiaries.

§ 1.668(b)–2 Illustration of the provisions of subpart D.

The provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, other than provisions relating to a foreign trust created by a U.S. person, may be illustrated by the following example:

Example. (a) *Facts.* (1) Under the terms of a trust instrument, one-half of the trust income is required to be distributed currently to beneficiary A. The trustee may in his discretion accumulate the balance of the income of the trust or he may make distributions to B out of income or corpus. The trust is to terminate upon the death of A and the corpus is to be distributed to B. Capital gains are allocable to corpus. All of the expenses of the trust are charges against income. The trust instrument provides for a reserve for depreciation, so that depreciation is deductible in computing distributable net income. The trust and both beneficiaries report on the calendar year basis. The trust had long-term capital gains of $20,000 for 1954, and $10,000 for 1955, which were allocated to corpus. The distributable net income of the trust as determined under section 643(a) for 1954, 1955, 1956, and 1957 is deemed to consist of the following items of income:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1954	$15,000	$20,000	$10,000	$5,000	$50,000
1955	10,000	15,000	10,000	5,000	40,000
1956	10,000	20,000	15,000	5,000	50,000
1957	10,000	15,000	15,000	5,000	45,000

(2) One-half ($7,500) of the dividends for 1954 was received by the trust on or before July 31, 1954, and the balance was received after that date.

(3) The following distributions were made by the trustee to A and B during the taxable years 1954 through 1957:

	A	B
1954	$25,000	None
1955	20,000	None
1956	25,000	$45,000
1957	22,500	29,550

(b) *Distributions to A.* A is deemed to have received one-half of each item of income entering into the computation of distributable net income as shown in paragraph (a)(1) of this example. See § 1.662(a)–2 for rules for the treatment of currently distributable income in the hands of the beneficiary.

(c) *Tax liability of the trust*—(1) *1954.* (i) The tax liability of the trust for the taxable year 1954 is $13,451, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$50,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		44,950
Add: Capital gains (long-term)		20,000
Total		64,950
Deductions:		
Distributions to A	$22,475	
Capital gain deduction	$10,000	
Personal exemption	100	
		32,575
Taxable income		32,375
Alternative tax		13,601
Dividend received credit		150
Tax liability		13,451

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half of the dividends of the trust is deemed to be distributed to A, $25 of such distribution is deemed to be made from the dividend exclusion of $50, and the balance from dividends included in the gross income of the trust (that is, since the year 1954 is involved, $3,725 from dividends received on or before July 31, 1954, and $3,750 from dividends received after July 31, 1954). The trust is entitled to a dividend received credit attributable to the dividends of $3,750 received after July 31, 1954, which were not distributed to any beneficiary during the taxable year.

(2) *1955.* (i) The tax liability of the trust for the taxable year 1955 is $8,189, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$40,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		34,950
Add: Capital gains (long-term)		10,000
Total		44,950
Deductions:		
Distributions to A	$17,475	
Capital gain deduction	5,000	
Personal exemption	100	
		22,575
Taxable income		22,375
Alternative tax		8,388
Dividend received credit		199
Tax liability		8,189

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half ($4,975) of the dividends of $9,950 ($10,000 less dividend exclusion of $50) included in the gross income of the trust is deemed distributed to A, the trust is entitled to a dividend received credit with respect to the dividends of $4,975 which were not distributed to any beneficiary during the taxable year.

(3) *1956 and 1957.* The trust had no tax liability for the taxable years 1956 and 1957 since all of its income was distributed during such years.

(d) *Accumulation distributions.* (1) Accumulation distributions of $20,000 and $7,050, as defined in section 665(b), were made to B during the years 1956 and 1957, respectively, computed as shown below:

	1956	1957
Distributable net income of the trust as computed under section 643(a)	$50,000	$45,000
Less. Income currently distributable to A	25,000	22,500
Balance of income	25,000	22,500
Other amounts distributed to B	45,000	29,550
Accumulation distributions to B	20,000	7,050

(2) B is deemed to have received one-half of each item of income entering into the computation of distributable net income (shown in paragraph (a)(1) of this example) for the years 1956 and 1957.

(3) The accumulation distribution for 1956 must first be allocated to the preceding taxable years as provided in section 666. After the application of the provisions of subpart D to the 1956 accumulation distribution and to the undistributed net incomes of the preceding taxable years, a similar allocation must be made of the 1957 accumulation distribution.

(e) *Throwback of 1956 accumulation distribution to 1955.* The accumulation distribution of $20,000 for 1956 must be allocated to the first preceding taxable year 1955, before allocation is made to the second preceding taxable year 1954.

(1) *1955 Undistributed net income.* (i) The undistributed net income of the trust for 1955, determined as of the close of 1955, is $12,885, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)		$40,000
Less:		
Distributions to A	$20,000	
Taxes imposed on the trust	7,115	
	27,115	
Undistributed net income as of the close of 1955	12,885	

(ii) The taxes imposed on the trust of $7,115 are that portion of the taxes paid by the trust for 1955 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the ''balance'' in the computation below) and is determined as follows:

Taxable income (paragraph (c)(2)(i) of this example			$22,375
Capital gains allocable to corpus		$10,000	
Less:			
Capital gain deduction	$5,000		
Personal exemption	100		
		5,100	
Portion of taxable income allocable to corpus			4,900
Balance			17,475
Total taxes paid by the trust			8,189
Taxes on income ($4,900) allocable to corpus			1,074
Taxes imposed on the trust (section 665(c))			7,115

(iii) The amount of $1,074 is the taxes which the trust would have paid for 1955 had all of the distributable net income been distributed during the year.

(2) *Allocation of 1956 accumulation distribution to the preceding taxable year 1955.* The portion of the 1956 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1955 (the first preceding taxable year) is $12,885, an amount equal to the undistributed net income for 1955. An additional amount equal to the taxes imposed on the trust ($7,115) is, under section 666(b), also deemed to be distributed to B on the last day of 1955. Thus, a total of $20,000 ($12,885 plus $7,115) is deemed to be distributed to B on December 31, 1955, by reason of the allocation of the 1956 accumulation distribution to the first preceding taxable year. See paragraph (h) of this example for the treatment of the amount of $20,000 in the hands of B.

(3) *Character of amounts deemed distributed.* Inasmuch as one-half of the 1955 distributable net income of the trust as determined under section 643(a) was currently distributable to A and the balance of such income is deemed under section 666 to be distributed to B on December 31, 1955, the distribution to B is deemed to consist of one-half of each item of income entering into the computation of the 1955 distributable net income; that is, dividends of $5,000, rents of $7,500, taxable interest of $5,000, and tax-exempt interest of $2,500.

(4) *Credit for taxes paid by the trust.* The amount of the taxes for the year 1955 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b) is $7,115. See also paragraph (h)(3) of this example.

(5) *Effect of application of provisions of subpart D to the year 1955.* After the allocation of the 1956 accumulation distribution to the preceding taxable year 1955, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1955 are zero. The portion of the 1956 accumulation distribution which is unabsorbed by the 1955 undistributed net income is $7,115, determined as follows:

1956 accumulation distribution (paragraph (d)(1) of this example)	$20,000
Less: Amount allocable to 1955	12,885
Balance allocable to second preceding taxable year 1954	7,115

(f) *Throwback of 1956 accumulation distribution to 1954.* The unabsorbed portion of the 1956 accumulation distribution of $7,115 is allocable to the second preceding taxable year 1954 and is treated under section 666 as a distribution to B on the last day of such year.

(1) *1954 Undistributed net income.* (i) The undistributed net income of the trust for 1954, determined as of the close of 1954, is $14,155, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)		$50,000
Less:		
Distributions to A	$25,000	
Taxes imposed on the trust	10,845	
		35,845
Undistributed net income as of the close of 1954		14,155

(ii) The taxes imposed on the trust of $10,845 are that portion of the taxes paid by the trust for 1954 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the ''balance'' in the computation below in this subdivision) and is determined as follows:

Taxable income (paragraph (c)(1)(i) of this example)			$32,375
Capital gains allocable to corpus		$20,000	
Less:			
Capital gain deduction	$10,000		
Personal exemption	100		
		10,100	
Portion of taxable income allocable to corpus			9,900
Balance			22,475
Total taxes paid by the trust			13,451
Taxes on income ($9,900) allocable to corpus			2,606
Taxes imposed on the trust (section 665(c))			10,845

(iii) The amount of $2,606 is the taxes which the trust would have paid for 1954 had all of the distributable net income been distributed during that year.

(2) *Allocation of 1956 accumulation distribution to the second preceding taxable year 1954.* Since the unabsorbed portion of the 1956 accumulation distribution of $7,115 is less than the 1954 undistributed net income of $14,155, the trust is deemed under section 666(c) to have also distributed an additional amount ($5,451) equal to a pro rata portion (7,115/14,155×$10,845) of the taxes imposed on the trust for 1954. Thus, a total of $12,566 ($7,115 plus $5,451) is deemed to be distributed to B on December 31, 1954, by reason of the throwback of the 1956 accumulation distribution. See paragraph (h) of this example for the treatment of the amount of $12,566 in the hands of B.

(3) *Character of amounts deemed distributed to B.* The amount of $12,566 which, under section 666, is deemed to be distributed to B on December 31, 1954, is deemed to be composed of the following items of income of the trust: Dividends, $3,770 (15,000/50,000×$12,566); rents, $5,026 (20,000/50,000×$12,566); taxable interest, $2,513 (10,000/50,000×$12,566); and tax-exempt interest, $1,257 (5,000/50,000×$12,566). One-half of the dividends of $3,770 is considered as distributed from the dividends received by the trust on or before July 31, 1954, of which $13 (3,770/15,000×$50) is deemed distributed from the dividends excluded under section 116, and the other half as distributed from the dividends received after July 31, 1954. Thus, of the total of $12,566 deemed distributed to B, $11,296 is considered as made from income included in the gross income of the trust and $1,270 from non-taxable income of the trust.

(4) *Credit for taxes paid by the trust.* The amount of the taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b), because of the allocation of the 1956 accumulation distribution to 1954, is $5,401, computed as follows:

Taxable income of the trust as of the close of 1954 (paragraph (c)(1) of this example)	$32,375
Less: Amount deemed distributed to B under section 666 from the taxable income of the trust	11,296
Taxable income adjusted as of the close of 1956	21,079
(Taxes on $21,079 (alternative tax)	$8,050
Taxes on income allocable to corpus (subparagraph (1)(ii) of this paragraph)	$2,606
Taxes imposed on the trust determined as of the close of 1956	5,444
Taxes imposed on the trust determined as of the close of 1954	$10,845
Taxes imposed on the trust determined as of the close of 1956	5,444
Amount of taxes allowed as a credit to B under section 668(b)	5,401

(5) *Effect of application of provisions of subpart D to the year 1954.* (i) The undistributed portion of the distributable net income of the trust for the year 1954, determined as of the close of 1956, is $12,434, computed as follows:

Distributable net income (section 643(a))		$50,000
Less:		
Amount currently distributable to A	$25,000	
Amount deemed distributed to B under section 666	12,566	
		37,566
Undistributed portion of distributable net income as of the close of 1956		12,434

(ii) The amount of $12,434 is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243, determined as follows:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
Trust income	$15,000	$20,000	$10,000	$5,000	[1] $50,000
Distributions:					
To A	7,500	10,000	5,000	2,500	[2] 25,000
To B	3,770	5,026	2,513	1,257	[3] 12,566
Total	11,270	15,026	7,513	3,757	37,566
Balance	3,730	4,974	2,487	1,243	12,434

[1] See paragraph (a)(1) of this example.
[2] See paragraph (b) of this example.
[3] See paragraph (f)(3) of this example.

(iii) The undistributed net income of the trust for 1954, determined as of the close of 1956, is $6,990, computed as follows:

Undistributed portion of distributable net income as of the close of 1956	$12,434

Less: Taxes imposed on the trust determined as of the close of 1956 (subparagraph (4) of this paragraph)	5,444
Undistributed net income as of the close of 1956	6,990

(g) *Throwback of 1957 accumulation distribution.* Inasmuch as all of the income of the trust for the first preceding taxable year 1956 was distributed during such year and the trust had no undistributed net income for the second preceding taxable year 1955 after the application of subpart D to the accumulation distribution made during 1956, the 1957 accumulation distribution of $7,050 is allocable to the third preceding taxable year 1954. See paragraph (d)(1) of this example for computation of the accumulation distribution.

(1) *Allocation of 1957 accumulation distribution to the preceding taxable year 1954.* The portion of the 1957 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1954 is $6,990, an amount equal to the undistributed net income of the trust for 1954, determined as of the close of 1956. An additional amount equal to the taxes imposed on the trust ($5,444), determined as of the close of 1956, is under section 666(b) also deemed to be distributed to B on the last day of 1954. See paragraph (f) (4) and (5) of this example. Thus, a total of $12,434 ($6,990 plus $5,444) is deemed to be distributed to B on December 31, 1954, by reason of the allocation of the 1957 accumulation distribution to the taxable year 1954. See paragraph (j) of this example for the treatment of the amount of $12,434 in the hands of B.

(2) *Character of amounts deemed distributed.* Inasmuch as the balance of the 1954 distributable net income of the trust is deemed under section 666 to be distributed to B on December 31, 1954, the distribution is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243. See paragraph (f)(5)(ii) of this example.

(3) *Credit for taxes paid by the trust.* The amount of taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B under section 668(b) is $5,444, the amount of taxes imposed on the trust determined as of the close of 1956. See paragraph (f)(4) of this example.

(4) *Effect of application of provisions of subpart D to the year 1954.* After the allocation of the 1957 accumulation distribution to the preceding taxable year 1954, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1954 are zero. The balance of $60 ($7,050 less $6,990) of the 1957 accumulation distribution remaining after the allocation of the accumulation distribution to the year 1954, may not be allocated to the year 1953 since that year is not subject to the provisions of the Internal Revenue Code of 1954.

(h) *Determination of B's tax liability; taxable year 1956*—(1) *Amount of trust income includible in gross income.* (i) Of the amount of $45,000 distributed by the trust to B during the taxable year 1956, $25,000 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and $20,000 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $12,885 plus taxes of $7,115 is deemed distributed to B on December 31, 1955, and $7,115 plus taxes of $5,451 on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1956, and these amounts are includible in B's gross income for 1956 to the extent that they would have been includible in his gross income under section 662 (a)(2) and (b) for 1955 and 1954, respectively, had they been distributed on the last day of those years.

(ii) The amounts distributed to B out of trust income for the year 1956, and the amounts deemed distributed out of income for the preceding taxable years 1955 and 1954 have the following character for the purpose of determining the amount includible in B's gross income for 1956:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1956	$5,000	$10,000	$7,500	$2,500	[1] $25,000
1955	5,000	7,500	5,000	2,500	[2] 20,000
1954	3,770	5,026	2,513	1,257	[3] 12,566
Total	13,770	22,526	15,013	6,257	57,566

[1] See paragraph (d)(2) of this example.
[2] See paragraph (e)(3) of this example.
[3] See paragraph (f)(3) of this example.

Thus, B will include in gross income for 1956 dividends of $13,770 (subject to the dividend exclusion), rents of $22,526, and taxable interest of $15,013, and will exclude the tax-exempt interest of $6,257.

(2) *Computation of tax.* (i) For the purpose of computing B's tax liability, it is assumed

that he was single during the taxable years 1954, 1955, and 1956, and that his taxable income (derived from salary) for each of the years 1954 and 1955 amounted to $13,400 on which a tax of $4,002 was paid for each year. It is also assumed that his income (other than distributions from the trust) for 1956 was $15,000 derived from salary, and he had allowable deductions of $10,600, which included the deduction for personal exemption.

(ii) The computation of the tax for the taxable year 1956 attributable to the section 666 amounts which are included in B's gross income for such year, as provided in paragraph (a)(1) of § 1.668(a)–4, is as follows:

	(1) Section 666 amounts excluded	(2) Section 666 amounts included
Salary	$15,000	$15,000
Income from trust:		
Dividends ($50 excluded)	4,950	13,720
Rents	10,000	22,526
Taxable interest	7,500	15,013
Total	37,450	66,259
Less: Allowable deductions	10,600	10,600
Taxable income	26,850	55,659
Total tax	11,267	31,064
Less: Dividend received credit	198	475
Tax liability	$11,069	30,589
Tax on income from which section 666 amounts are excluded	....	11,069
1956 tax attributable to section 666 amounts	....	19,520

Only that portion of the dividends received by the trust after July 31, 1954, and deemed distributed to B under section 666, on the last day of such year is included in computing the dividend received credit shown in column (2). See paragraph (f)(3) of this example.

(iii) The computation of the taxes for the preceding taxable years attributable to the section 666 amounts which are deemed distributed by the trust on the last day of these years, as provided in paragraph (a)(2) of § 1.668(a)–4, is as follows:

	Preceding taxable years	
	First 1955	Second 1954
Taxable income previously reported	$13,400	$13,400
Section 666 amounts:		
Dividends ($50 excluded)	4,950	3,720
Rents	7,500	5,026
Taxable interest	5,000	2,513
Taxable income as adjusted	30,850	24,659
Total tax	13,747	9,949
Less: Dividend received credit	198	75
Balance of tax	13,549	9,874
Tax liability	4,002	4,002
Tax attributable to section 666 amounts	9,547	5,872

Only that portion ($1,885) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $75 for the year 1954. See paragraph (f)(3) of this example.

(iv) Inasmuch as the aggregate of the taxes of $15,419 ($9,547 plus $5,872) attributable to the section 666 amounts as determined for the preceding taxable years is less than the tax of $19,520 determined for the taxable year 1956, the amount of $15,419 shall be added to the tax computed for 1956 without including the section 666 amounts. Thus, B's tax liability for 1956 is $26,488 ($11,069 plus $15,419).

(3) *Credits against the tax.* B is allowed under section 668(b) a credit of $12,516 ($5,401 for 1954 and $7,115 for 1955) against his 1956 tax liability for the taxes paid by the trust for the preceding taxable years and which may not be refunded or credited to the trust under section 667. See paragraphs (e)(4) and (f)(4) of this example.

(i) [Reserved]

(j) *Taxable year 1957*—(1) *Amount of trust income includible in gross income.* (i) Of the amount of $29,550 distributed by the trust to B during the taxable year 1957, $22,500 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and $7,050 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $6,990 plus taxes of $5,444 is deemed distributed to B on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1957, and that amount is includible in B's gross income for 1957, to the extent that it would have been includible in his gross income under section 662 (a)(2) and (b) for 1954, had it been distributed on the last day of that year.

(ii) The amounts deemed distributed to B out of trust income for the year 1957 and the preceding taxable year 1954 are deemed to have the following character for the purpose of determining the amount includible in B's gross income for 1957:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1957	$5,000	$7,500	$7,500	$2,500	[1] $22,500
1954	3,730	4,974	2,487	1,243	[2] 12,434
Total	8,730	12,474	9,987	3,743	34,934

[1] See paragraph (d)(2) of this example.
[2] See paragraph (g)(2) of this example.

Thus, B will include in gross income for the year 1957 dividends of $8,730 (subject to the dividend exclusion), rents of $12,474, and taxable interest of $9,987 and will exclude the tax-exempt interest of $3,743.

(2) *Computation of tax.* (i) For the purpose of computing B's tax liability for 1957, it is assumed that he was single for the entire year and had income (other than distributions from the trust) of $15,000 from salary. Also, he had allowable deductions of $8,100, which included the deductions for personal exemption.

(ii) The computation of the tax for the taxable year 1957 attributable to the section 666 amounts which are included in B's gross income for that year, as provided in paragraph (a)(1) of § 1.668(a)–4, is as follows:

	Section 666 amounts excluded	Section 666 amounts included
Salary	$15,000	$15,000
Trust income:		
Dividends ($50 excluded)	4,950	8,680
Rents	7,500	12,474
Taxable interest	7,500	9,987
Total	34,950	46,141
Less: Allowable deductions	8,100	8,100
Taxable income	26,850	38,041
Total tax	11,267	18,388
Less: Dividends received credit	198	275
Tax liability	11,069	18,113
Tax on income from which section 666 amounts are excluded		11,069
1957 tax attributable to section 666 amounts		7,044

See explanation following computation in paragraph (h)(2)(ii) of this example with respect to the computation of the dividend received credit on dividends received by the trust in 1954.

(iii) The amount of tax, computed at 1954 rates, attributable to the section 666 amounts which are deemed to have been distributed by the trust on the last day of 1954, is $6,939, computed as follows:

1954 taxable income as adjusted (paragraph (h)(2)(iii) of this example)		$24,659
Section 666 amounts:		
Dividends		3,730
Rents		4,974
Taxable interest		2,487
Taxable income as adjusted		35,850
Total tax		16,963
Less: Dividends received credit		150
Balance of tax		16,813
Tax liability for 1954	$4,002	
Tax attributable to 1956 accumulation distribution this example)	5,872	
		9,874
Tax attributable to the section 666 amounts distributed in 1957		6,939

Only that portion ($3,750) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $150. See paragraphs (f)(3) and (g)(2) of this example.

(iv) Inasmuch as the tax of $6,939 attributable to the section 666 amounts as determined for the preceding taxable year 1954 is less than the tax of $7,044 attributable to these amounts for the year 1957, the amount of $6,939 shall be added to the tax computed for 1957 without including in gross income the section 666 amounts. Thus, B's tax liability for 1957 is $18,008 ($11,069 plus $6,939).

(3) *Credit against the tax.* B is allowed under section 668(b) a credit of $5,444 against his 1957 tax liability for the balance of the taxes paid by the trust for 1954 and which may not be refunded or credited to the trust under section 667. See paragraph(g)(3) of this example.

(Sec. 669(a) as amended by sec. 331(a), Tax Reform Act 1969 (83 Stat. 592))

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 738, Jan. 17, 1969]

§ 1.669(a)–1A Amount allocated.

(a) *In general.* After a trust has distributed all of its undistributed net income, the rules concerning the treatment of capital gain distributions (prescribed under section 669) may become applicable to an accumulation distribution. This section prescribes rules to determine from which years capital gain distributions are considered to be made. For the definition of ''capital gain distribution,'' see § 1.665(g)–1A. Section 669 does not apply to a trust that has distributed all of its income currently since its inception. See § 1.668(a)–1A(c). Capital gain retains its character in the hands of the beneficiary. See § 1.669(f)–1A. A capital gain distribution to more than one beneficiary will be allocated among them. See § 16.668(a)–2A.

(b) *First-in, first-out rule.* A capital gain distribution is allocated to the preceding taxable years of the trust (as defined in § 1.665(e)–1A(a)(1)(iii)), according to the undistributed capital gain of the trust for such years. For this purpose, a capital gain distribution is first allocated to the earliest such preceding taxable year in which there is undistributed capital gain and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the capital gain distribution allocated to the earliest preceding taxable year is the amount of undistributed capital gain for that preceding taxable year. The portion of the capital gain distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the capital gain distribution over the aggregate of the undistributed capital gain for all earlier preceding taxable years. See paragraph (c) of this section for adjustments to undistributed capital gain for prior distributions.

(c) *Reduction of undistributed capital gain for prior capital gain distributions.* For the purposes of allocating to any preceding taxable year a capital gain distribution of the taxable year, the undistributed capital gain of such preceding taxable year is reduced by the amount from such year deemed distributed in any capital gain distribution made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust subject to the capital gain throwback has no undistributed net income but has undistributed capital gain for 1974, and makes capital gain distributions during the taxable years 1978 and 1979, then in determining that part of the 1979 capital gain distribution that is thrown back to 1974, the undistributed capital gain for 1974 is reduced by the amount of such undistributed capital gain for 1974 deemed distributed in the 1978 capital gain distribution.

(d) *Rule when no undistributed capital gain.* If, before the application of the provisions of subpart D to a capital gain distribution for the taxable year, there is no undistributed capital gain for a preceding taxable year, then no portion of the capital gain distribution is deemed distributed on the last day of such preceding taxable year. Thus, for example, if a capital gain distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed capital gain for 1970, then no portion of the 1975 capital gain distribution is deemed distributed on the last day of 1970.

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

Example. In 1977, a trust reporting on the calendar year basis makes a capital gain distribution of $33,000. In 1969, the trust had $6,000 of undistributed capital gain; in 1970, $4,000; in 1971, none; in 1972, $7,000; in 1973, $5,000; in 1974, $8,000; in 1975, $6,000; in 1976, $4,000; and $6,000 in 1977. The capital gain distribution is deemed distributed $6,000 in 1969, $4,000 in 1970, none in 1971, $7,000 in 1972, $5,000 in 1973, $8,000 in 1974, and $3,000 in 1975.

[T.D. 7204, 37 FR 17153, Aug. 25, 1972]

§ 1.669(b)–1A Tax on distribution.

(a) *In general.* The partial tax imposed on the beneficiary by section 668(a)(3) shall be the lesser of:

(1) The tax computed under paragraph (b) of this section (the ''exact'' method), or

(2) The tax computed under paragraph (c) of this section (the ''shortcut'' method),

except as provided in § 1.669(c)–3A (relating to failure to furnish proper information) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary's choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(2).

(b) *Computation of partial tax by the exact method.* The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 669 amounts for each of the preceding taxable years. For purposes of this paragraph, the ''section 669 amounts'' for a preceding taxable year are the amounts deemed distributed under section 669(a) on the last day of such preceding taxable year, plus the amount of taxes deemed distributed on such day under section 669 (d) or (e). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary's gross income and the tax for such year computed with the inclusion of them in such gross income. Tax computations for each such year shall reflect a taxpayer's marital, dependency, exemption, and filing status for such year. To the extent the undistributed capital gain of a trust deemed distributed in a capital gain distribution includes amounts received as a capital gain distribution from another trust, for purposes of this paragraph they shall be considered as amounts deemed distributed by the trust under section 669(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust, that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 669(a) amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.669(d)–1A and 1.669(e)–1A as does not exceed such sum. The resulting amount, if any, is the partial tax on the beneficiary, computed under the exact method, for the taxable year in which the capital gain distribution is paid, credited, or required to be distributed to the beneficiary.

(c) *Computation of tax by the short-cut method.* (1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received a capital gain distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such capital gain distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust, that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed capital gain deemed distributed is less than 25 percent of *(a)* the total amounts deemed under section 669(a) to be undistributed capital gain from preceding taxable years, divided by *(b)* the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed without application of this sentence. For example, assume that a capital gain distribution of $90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of $29,000 in each of the years 1972, 1973, and 1974, and $3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is 4. However, the distribution deemed made in 1975 ($3,000) is less than $5,625, which is 25 percent of *(a)* the total undistributed capital gain deemed distributed under section 669(a) ($90,000) divided by *(b)* the number of such preceding taxable years (4), or $22,500. Therefore, for purposes of this subparagraph, the capital gain distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the capital gain distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (determined as provided in subdivision (i) of this paragraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of long-term and short-term capital gain as the total of each type of capital gain deemed distributed in the capital gain distribution bears to the total undistributed capital gain from such preceding taxable years deemed distributed in the capital gain distribution. For example, assume that an amount of $50,000 is deemed distributed under section 669(a) from undistributed capital gain of 5 preceding taxable years of the trust, and consists of $30,000 of long-term capital gain and $20,000 of short-term capital gain. Taxes attributable to such amounts in the amount of $10,000 are also deemed distributed. The amount determined under this subdivision, $12,000 ($50,000 income plus $10,000 tax, divided by 5 years), is deemed to consist of $7,200 of long-term capital gain and $4,800 in short-term capital gain.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the capital gain distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.

The difference between the amount of tax computed under (a) of this subdivision for each year and the amount computed under (b) of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3.

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (previously determined under subdivision (i) of this subparagraph).

(vi) The resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.669(d)–1A and 1.669(e)–1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 669(b)(1)(B).

(2) See § 1.668(b)–1A(c) for examples of the short-cut method in the context of an accumulation distribution.

(d) *Disallowance of short-cut method.* If, in any prior taxable year of the beneficiary in which any part of the capital gain distribution is deemed to have been distributed under section 669(a) to such beneficiary, any part of prior capital gain distributions by each of two or more other trusts is deemed under section 669(a) to have been distributed to such beneficiary, then the short-cut method under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(3) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes a capital gain distribution to A, who is on the calendar year basis, and part of the distribution is deemed under section 669(a) to have been distributed on March 31, 1974. In 1977, A had received a capital gain distribution from both trust Y and trust Z. Part of the capital gain distribution from trust Y was deemed under section

669(a) to have been distributed to A on June 30, 1974, and part of the capital gain distribution from trust Z was deemed under section 669(a) to have been distributed to A on December 31, 1974. Because there were portions of capital gain distributions from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 capital gain distribution from trust X may not be computed under the short-cut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 668(a)(3).

[T.D. 7204, 37 FR 17153, Aug. 25, 1972]

§ 1.669(c)–1A Special rules applicable to section 669.

(a) *Effect of other distributions.* The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under § 1.669(b)–1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a *prior accumulation distribution* is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term *prior accumulation distribution* also includes accumulation distributions of the same or other trusts which were distributed to the beneficiary in the same taxable year. The term ''prior capital gain distribution'' also includes capital gain distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (b) of this section to treat as having been distributed before the capital gain distribution for which tax is being computed under § 1.669(b)–1A.

(b) *Multiple distributions in the same taxable year.* For purposes of paragraph (a) of this section, capital gain distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several capital gain distributions. The beneficiary shall indicate the order he has determined to deem the capital gain distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(c) *Rule when beneficiary not in existence on the last day of a taxable year.* If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 669(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of § 1.669(b)–1A, that the beneficiary:

(1) Was in existence on such last day,

(2) Was a calendar year taxpayer,

(3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,

(4) If an individual, was unmarried and had no dependents,

(5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and

(6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of a capital gain distribution made in 1980 is deemed under section 669(a) to have been distributed to the beneficiary, A, in 1973. $10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of § 1.669(b)–1A that A was alive in 1973, was on the calendar year basis, had no income other than (i) the $10,000 from the accumulation distribution deemed distributed in 1973 and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A's first actual taxable year.

(d) *Examples.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. In 1978, trust X made a capital gain distribution to A, a calendar year taxpayer, of which $3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another capital gain distribution to A, $10,000 of which is deemed under section 669(a) to have been distributed in 1974. Also in 1980, trust Y makes a capital gain distribution to A, of which $5,000 is deemed under section 669(a) to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A's gross income for 1974 includes (i) the $3,000 deemed distributed from the 1978 distribution, and (ii) the $5,000 deemed distributed in 1974 from the 1980 Trust Y capital gain distribution. To compute A's tax under the exact method for 1974 on the $10,000 from the 1980 trust X capital gain distribution deemed distributed in 1974. A's gross income for 1974 includes (i) the $10,000, (ii) the $3,000 previously deemed distributed in 1974 from the 1978 trust X capital gain distribution, and (iii) the $5,000 deemed distributed in 1974 from the 1980 trust Y capital gain distribution.

Example 2. In 1978, trust T makes a capital gain distribution to B, a calendar year taxpayer. Determination of the tax on the distribution under the short-cut method requires the use of B's gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution from trust U, of which $2,000 was deemed to have been distributed in 1975, and $3,000 in 1976. B's gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T capital gain distribution, will be deemed to include the $2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the $3,000 deemed distributed by trust U in 1976.

[T.D. 7204, 37 FR 17155, Aug. 25, 1972]

§ 1.669(c)–2A Computation of the beneficiary's income and tax for a prior taxable year.

(a) *Basis for computation.* (1) The beneficiary's income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under § 1.669(c)–3A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for recomputation purposes. The term *as finally determined* shall have the same meaning for purposes of this section as in § 1.668(b)–3A(a).

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary's gross income, and the tax for such year computed without including such amounts in such gross income, shall be based upon the return after the correction of such mathematical errors.

(b) *Effect of allocation of undistributed capital gain on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover.* (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed capital gain allocated to such year. For example, if $2,000 of undistributed long-term capital gain is allocated to 1970, adjusted gross income for 1970 is increased from $5,000 to $6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed capital gain deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed capital gain on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by such amounts so allocated.

[T.D. 7204, 37 FR 17155, Aug. 25, 1972]

§ 1.669(c)–3A Information requirements with respect to beneficiary.

(a) *Information to be supplied by beneficiary*—(1) *Use of exact method.* The beneficiary must supply the information required by subparagraph (3) of § 1.668(b)–4A(a) for any prior taxable year for which a recomputation is required under either the exact method or the short-cut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(3) is imposed.

(2) *Failure to furnish.* If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and the tax computed under paragraph (c) of § 1.669(b)–1A (the short-cut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(3). See, however, paragraph (b) of this section for an exception to this rule where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(b) *Exception.* If, by reason of § 1.669(b)–1A(e), the beneficiary may not compute the partial tax on the capital gain distribution under § 1.669(b)–1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by § 1.668(b)–4A(a)(3) for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(d)–1A Total taxes deemed distributed.

(a) If a capital gain distribution is deemed under § 1.669(a)–1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed capital gain for such preceding taxable year, then an additional amount equal to the ''taxes imposed on the trust attributable to the undistributed capital gain'' (as defined in § 1.665(d)–1A(c)) for such preceding taxable year is also deemed to have been properly distributed. For example, assume a trust has no distributable net income and has undistributed capital gain of $18,010 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed capital gain are $2,190. During the taxable year 1977, a capital gain distribution of $18,010 is made to the beneficiary which is deemed under § 1.669(a)–1A to have been distributed on the last day of 1974. The 1977 capital gain distribution is not less than the 1974 undistributed capital gain. Accordingly, taxes of $2,190 imposed on the trust attributable to the undistributed capital gain for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of $20,200 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)–1A.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(e)–1A Pro rata portion of taxes deemed distributed.

(a) If a capital gain distribution is deemed under § 1.669(a)–1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed capital gain for such preceding taxable year, then an additional amount is also deemed to have been properly distributed. The additional amount is equal to the ''taxes imposed on the trust attributable to the undistributed capital gain'' (as defined in § 1.665(d)–1A(c)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the capital gain distribution allocated to such preceding taxable year and the denominator of which is the undistributed capital gain for such preceding taxable year. See paragraph (b) of example 1 and paragraphs (c) and (f) of example 2 in § 1.669(e)–2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)–1A, paragraph (c) of example 1 and paragraphs (e) and (h) of example 2 in § 1.669(e)–2A.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(e)–2A Illustration of the provisions of section 669.

The application of the provisions of §§ 1.669(a)–1A, 1.669(d)–1A, and 1.669(e)–1A may be illustrated by the following examples:

Example 1. (a) A trust created on January 1, 1974, makes capital gain distributions as follows:

1979	$14,000
1980	60,000

The trust had accumulated income in 1974.

For 1974 through 1978, the undistributed portion of capital gain, taxes imposed on the trust attributable to the undistributed capital gain, and undistributed capital gain are as follows:

Year	Undistributed portion of capital gain	Taxes imposed on the trust attributable to the undistributed capital gain	Undistributed capital gain
1974	$24,200	$2,830	$21,370
1975	32,200	4,330	27,870
1976	12,200	1,130	11,070
1977	None	None	None
1978	10,200	910	9,290

(b) Since the entire amount of the capital gain distribution for 1979 ($14,000), determined without regard to the capital gain distribution for 1980, is less than the undistributed capital gain for 1974 ($21,370), an additional amount of $1,854 (14,000/21,370× $2,830) is deemed distributed under section 669(e).

(c) In allocating the capital gain distribution for 1980, the amount of undistributed capital gain for 1974 will reflect the capital gain distribution for 1979. The undistributed capital gain for 1974 will then be $7,370 and the taxes imposed on the trust for 1974 will be $976, determined as follows:

Undistributed capital gain as of the close of 1974	$21,370
Less: Capital gain distribution (1979)	14,000
Balance (undistributed capital gain as of the close of 1979)	7,370
Taxes imposed on the trust attributable to the undistributed capital gain as of the close of 1979 (7,370/ 21,370×2,830)	976

(d) The capital gain distribution of $60,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of $55,600, the total of the undistributed capital gain for such years, as shown in the tabulation below. In addition, $7,346, the total taxes imposed on the trust attributable to the undistributed capital gain for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed capital gain	Taxes imposed on the trust attributable to the undistributed capital gain
1974	$7,370	$976
1975	27,870	4,330
1976	11,070	1,130
1977	None	None
1978	9,290	910
1979	None	None
Total	55,600	7,346

Example 2. (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The trust is subject to capital gain throwback. Both X and the trust report on the calendar year basis. All of the income for 1974 was distributed and the capital gain was accumulated. The capital gain of the trust for the taxable year 1974 is $40,200 and the income taxes paid by the trust for 1974 attributable to the undistributed capital gain are $6,070. All of the income and capital gains for 1975 and 1976 were distributed and in addition the trustee made capital gain distributions within the meaning of section 665(g) of $8,000 for each year.

(b) The undistributed capital gain of the trust determined under section 665(f) as of the close of 1974 is $34,130, computed as follows:

Capital gain	$40,200
Less: Taxes imposed on the trust attributable to the undistributed capital gain	6,070
Undistributed capital gain as of the close of 1974	34,130

(c) The capital gain distribution of $8,000 made during the taxable year 1975 is deemed under section 669(a) to have been made on December 31, 1974. Since this capital gain distribution is less than the 1974 undistributed capital gain of $34,130, a portion of the taxes imposed on the trust for 1974 is also deemed under section 669(e) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974, is $9,486, computed as follows:

Capital gain distribution	$8,000
Taxes deemed distributed (8,000/34,130×$6,070)	1,423
Total	9,423

(d) After the application of the provisions of subpart D to the capital gain distribution of 1975, the undistributed capital gain of the trust for 1974 is $26,130, computed as follows:

Undistributed capital gain as of the close of 1974	$34,130
Less: 1975 capital gain distribution deemed distributed on December 31, 1974 (paragraph (c) of this example)	8,000
Undistributed capital gain for 1974 as of the close of 1975	26,130

(e) The taxes imposed on the trust attributable to the undistributed capital gain for the taxable year 1974, as adjusted to give effective to the 1975 capital gain distribution, amount to $4,647, computed as follows:

Taxes imposed on the trust attributable to undistributed capital gain as of the close of 1974	$6,070
Less: Taxes deemed distributed in 1974	1,423
Taxes attributable to the undistributed capital gain determined as of the close of 1975	4,647

(f) The capital gain distribution of $8,000 made during the taxable year 1976 is, under section 669(a), deemed an amount properly distributed to X on December 31, 1974. Since the capital gain distribution is less than the 1974 adjusted undistributed capital gain of $26,130, the trust is deemed under section 669(e) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the capital gain distribution made in 1976, is $9,423, computed as follows:

Capital gain distribution	$8,000
Taxes deemed distributed (8,000/26,130×$4,647)	1,423
Total	9,423

(g) After the application of the provisions of subpart D to the capital gain distribution of 1976, the undistributed capital gain of the trust for 1974 is $18,130, computed as follows:

Undistributed capital gain for 1974 as of the close of 1975	$26,130
Less:	
1976 capital gain distribution deemed distributed on December 31, 1974 (paragraph (f) of this example)	8,000
Undistributed capital gain for 1974 as of the close of 1976	18,130

(h) The taxes imposed on the trust attributable to the undistributed capital gain of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to $3,224 ($4,647 less $1,423).

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(f)–1A Character of capital gain.

Amounts distributed as a capital gain distribution and the taxes attributable thereto (determined under § 1.665(d)–1A(c)) retain the character that the gain had with respect to the trust. Thus, a capital gain that was taxed to the trust as a ''long-term'' capital gain and the pro rata amount of taxes attributable to such long-term gain shall be treated to the beneficiary as a ''long-term'' capital gain when they are deemed distributed as part of a capital gain distribution. If a trust has different types of capital gain for the same taxable year, and all of the capital gains are not deemed distributed for such year under section 669(a), the amount deemed distributed from such year (including taxes deemed distributed) shall be treated as consisting of the different types of gains in the ratio that the total of each such type of gains of the trust bears to the total of all such gains for the taxable year. For example, assume that in 1975 a trust had net long-term capital gains of $4,000 and net short-term capital gains of $2,000. Taxes attributable to such undistributed capital gain were $700. Therefore, undistributed capital gain for 1975 is $5,300. In 1980, the trust distributes $2,650 that is deemed to be undistributed capital gain from 1975. Such distribution is deemed to consist of long-term gain of $1,766.67 and short-term gain of $883.33. The taxes deemed distributed of $350 consist of long-term gain of $233.33 and short-term gain of $116.67.

[T.D. 7204, 37 FR 17157, Aug. 25, 1972]

§ 1.669(f)–2A Exception for capital gain distributions from certain trusts.

(a) *General rule.* If a capital gain distribution is paid, credited, or required to be distributed before January 1, 1973, from a trust that was in existence on December 31, 1969, section 669 shall not apply and no tax shall be imposed on such capital gain distribution under section 668(a)(3). If capital gain distributions from more than one such trust are paid, credited, or required to be distributed to a beneficiary before January 1, 1973, the exception under the preceding sentence shall apply only to the capital gain distributions from one of the trusts. The beneficiary shall indicate on his income tax return for the taxable year in which the distribution would otherwise be included in income under section 668(a) the trust to which the exception provided by this section shall apply.

(b) *Special rule for section 2056(b)(5) trust.* A capital gain distribution paid, credited, or required to be distributed by a trust that qualifies under section 2056(b)(5) of the Code (commonly known as a ''marital deduction trust'') to a surviving spouse shall, in general, not be taxed under section 668(a)(3) since such a trust is required to distribute all of its income annually or more often. See section 2056(b)(5) and the regulations thereunder.

(c) *Effect of exception.* If this section applies to a capital gain distribution from a trust, such distribution shall reduce the undistributed capital gain of the trust. Since section 669 does not apply to such capital gain distribution, no amount of taxes paid by the trust attributable to such capital gain distribution are deemed distributed under section 669 (d) and (e).

[T.D. 7204, 37 FR 17157, Aug. 25, 1972]

§ 1.669(a)–1 Limitation on tax.

(a) *In general.* Section 669 provides that, at the election of a beneficiary who is a U.S. person (as defined in section 7701(a)(30)) and who satisfies the requirements of section 669(b) (that certain information with respect to the operation and accounts of the trust be supplied), the tax attributable to the amounts treated under section 668(a) as having been received by him, from a foreign trust created by a U.S. person, on the last day of a preceding taxable year of the trust shall not be greater than the tax computed under section 669(a)(1)(A) (the computation under this provision will hereinafter be referred to as the ''exact throwback'' method) or under section 669(a)(1)(B) (the computation under this provision will hereinafter be referred to as the ''short-cut throwback'' method). This election of the beneficiary with respect to the taxable year of the beneficiary in which the distribution is made shall be made with the district director before the expiration of the period of limitations for assessment provided in section 6501 for such taxable year.

(b) *Where no election is made.* If the beneficiary does not make the election provided in section 669(a) in the manner required in section 669(b) and § 1.669(b)–2, or furnish the information with respect to the operation and accounts of the foreign trust created by a U.S. person required by section 669(b) and § 1.669(b)–1, the tax on an accumulation distribution treated under section 668(a) as having been received by him from such foreign trust on the last day of a preceding taxable year of the trust shall be computed without reference to section 668 or 669. In such case, the entire accumulation distribution will be included in the gross income of the beneficiary in the year in which it is paid, credited, or required to be distributed, and tax for such year will be computed on the basis of the beneficiary's total taxable income for the year after taking into account such inclusion in gross income.

(c) *Year for which tax is payable.* The tax, regardless of the manner in which computed, of the beneficiary which is attributable to an accumulation distribution is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made to him unless the taxable year of the beneficiary is different from that of the trust. See section 662(c) and § 1.662(c)–1.

[T.D. 6989, 34 FR 738, Jan. 17, 1969]

§ 1.669(a)–2 Rules applicable to section 669 computations.

(a) *In general.* (1) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the foreign trust created by a U.S. person on the last day of a preceding taxable year of such trust shall be included in the gross income of the beneficiary or the beneficiaries who are U.S. persons receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amount would have been included in his gross income under section 662 (a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and § 1.662(c)–1). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules contained in section 662(b) and §§ 1.662(b)–1 and 1.662(b)–2.

(2) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in subparagraph (1) of this paragraph in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(3) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of the amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

(b) *Allocation among beneficiaries of a foreign trust.* Where there is more than one beneficiary the portion of the total amount includible in gross income under paragraph (a) of this section which is includible in the gross income of a beneficiary who is a U.S. person is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year in which distributed (and not for the preceding taxable year). This paragraph may be illustrated by the example in § 1.668(a)–2.

(c) *Treatment of income taxes paid by the trust*—(1) *Current distributions.* The income taxes imposed by the provisions of section 871 on the income of a foreign trust created by a U.S. person shall be included in the gross income of the beneficiary, who is a U.S. person, for the taxable year in which such income is paid, credited, or required to be distributed to the beneficiary.

(2) *Accumulation distribution.* (i) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year is likewise deemed distributed under section 661(a)(2).

(ii) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount (representing taxes) is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year, multiplied by the fraction the numerator of which is the amount of the accumulation distribution attributable to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year.

(3) *Credits under sections 32 and 668(b).* Credit under section 32 is allowable to the beneficiary for income taxes withheld at source under subchapters A and B of chapter 3 and which are deemed distributed to him. Credit under section 668(b) is allowable to the beneficiary for income taxes imposed upon the foreign trust by section 871(b). These credits shall be allowed against the tax of the beneficiary for the taxable year of the beneficiary in which the income is paid, credited, or required to be distributed to him, or in which the accumulation distribution to which such taxes relate is made to him.

(d) *Credit for foreign income taxes paid by the trust.* To the extent provided in section 901, credit under section 33 is allowable to the beneficiary for the foreign taxes paid or accrued by the trust to a foreign country.

[T.D. 6989, 34 FR 738, Jan. 17, 1969]

§ 1.669(a)–3 Tax computed by the exact throwback method.

(a) *Tax attributable to amounts treated as received in preceding taxable years.* If a taxpayer elects to compute the tax, on amounts deemed distributed under section 666, by the exact throwback method provided in section 669(a)(1)(A), the tax liability of the beneficiary for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed is computed as provided in paragraph (b) of this section. The beneficiary may not elect to use the exact throwback method of computing his tax on an accumulation distribution as provided in section 669(a)(1)(A) if he were not alive on the last day of each preceding taxable year of the foreign trust created by a U.S. person with respect to which a distribution is deemed made under section 666(a). Thus, if a portion of an amount received as an accumulation distribution was accumulated by the trust during years before the beneficiary was born, the beneficiary is not permitted to elect the exact throwback method provided in section 669(a)(1)(A). See § 1.669(a)–4 for the computation of the tax on an accumulation distribution by the short-cut throwback method provided in section 669(a)(1)(B) under these circumstances.

(b) *Computation of tax.* The tax referred to in paragraph (a) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years. To determine the section 666 amounts attributable to each of the preceding taxable years, see § 1.666(a)–1. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding taxable year computed with the inclusion of the section 666 amounts in gross income, and the tax for such year computed without including them in gross income. Tax computations for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(2) Second, add

(i) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), and

(ii) The tax for the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him, computed without including the section 666 amounts in gross income.

The total of these amounts is the beneficiary's tax, computed under section 669(a)(1)(A) for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to him.

(c) *Effect of prior election.* In computing the tax attributable to an accumulation distribution for the taxable year in which such accumulation distribution is paid, credited, or required to be distributed to him, the beneficiary in computing the tax attributable to section 666 amounts for each of the preceding taxable years, must include in his gross income for each such year the section 666 amounts deemed distributed to him in such year resulting from prior accumulation distributions made to him in taxable years prior to the current taxable year. These section 666 amounts resulting from such prior accumulation distributions must be included in the gross income for such preceding taxable year even though the tax on the accumulation distribution of such prior taxable year was computed by the short-cut throwback method provided in section 669(a)(1)(B) and § 1.669(a)–4.

[T.D. 6989, 34 FR 739, Jan. 17, 1969]

§ 1.669(a)–4 Tax attributable to short-cut throwback method.

(a) *Manner of computing tax.* If a beneficiary has elected under section 669(a) to compute the tax on the amounts deemed distributed under section 666 by the short-cut throwback method provided in section 669(a)(1)(B), the tax liability of the beneficiary for the taxable year is computed in the following manner:

(1) First, determine the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed. In any case where there has been a prior accumulation distribution with respect to which the beneficiary has elected to compute his tax either by the exact throwback method or by the short-cut throwback method, or to which the next to the last sentence of section 668(a) has applied, for purposes of an election to use the short-cut throwback method with respect to a subsequent accumulation distribution, in determining the number of preceding taxable years of the trust with respect to which an amount of the subsequent accumulation distribution is deemed distributed to a beneficiary under section 666(a), there shall be excluded any preceding taxable year during which any part of the prior accumulation distribution was deemed distributed to the beneficiary. For example, assume that an accumulation distribution of $90,000 made to a beneficiary in 1963 is deemed distributed in the amounts of $25,000 in each of the years 1962, 1961, and 1960, and in the amount of $15,000 in 1959, and a subsequent accumulation distribution of $85,000 made to the same beneficiary in 1964 is deemed distributed in the amount of $10,000 during 1959, and $25,000 during each of the years 1958, 1957, and 1956. The accumulation distribution made in 1963 is deemed distributed in 4 preceding taxable years of the trust (1962, 1961, 1960, and 1959). Inasmuch as the year 1959 was a year during which part of the 1963 accumulation distribution was deemed distributed, for purposes of determining the number of preceding taxable years in which the accumulation distribution of $85,000 made in 1964 is deemed distributed, the year 1959 is excluded and the $85,000 accumulation distribution is deemed distributed in three preceding taxable years (1958, 1957, and 1956),

(2) Second, divide the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subparagraph (1) of this paragraph) into the amount (representing an accumulation distribution made by a foreign trust created by a U.S. person) required to be included under section 669(a) in the gross income of the beneficiary for the taxable year,

(3) Third, compute the tax of the beneficiary for the current taxable year (the year in which the accumulation distribution is paid, credited, or required to be distributed to him) and for each of the 2 taxable years immediately preceding such year,

(i) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subparagraph (2) of this paragraph, and

(ii) Without such inclusion.

The difference between the amount of tax computed under subdivision (i) of this subparagraph for each year and the amount computed under subdivision (ii) of this subparagraph for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subparagraph (2) of this paragraph. If the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed, is less than three, the taxable years of the beneficiary for which this recomputation is made shall equal the number of years in which an amount is deemed under section 666(a) to have been distributed, commencing with the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him. If the beneficiary was not alive during one of the two taxable years immediately preceding the taxable year, the tax resulting from the inclusion of the amount determined in subparagraph (2) of this paragraph in the gross income of the beneficiary will be computed only for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him and the preceding year during which the beneficiary was alive. In the event the beneficiary was not alive during either of the 2 years immediately preceding the taxable year in which the accumulation distribution was paid, credited, or required to be distributed, the tax shall be computed on the basis of the beneficiary's taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B). For example, assume that a foreign trust created by a U.S. person accumulates $3,000 of income in 1964 and $7,000 in 1963 and then distributes the accumulated income on January 1, 1965, to a beneficiary who is a U.S. person. The limitation on tax is determined by recomputing the beneficiary's gross income for 1964 and 1965 by adding $5,000 to his gross income for each year. If the same distribution were made to an infant who was born in 1965, the limitation on tax would be computed by adding $5,000 to his gross income for such year. In the case of the infant, the resulting increase in tax would be multiplied by two to arrive at the limitation on the increase in his tax for 1965 attributable to such distribution.

(4) Fourth, add the additional taxes resulting from the application of subparagraph (3) of this paragraph for the taxable year and the 2 taxable years (or the 1 taxable year, where applicable) immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed and then divide this amount by three (or two, where applicable). The resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subparagraph (1) of this paragraph). The resulting amount is the tax, under the short-cut throwback method provided in section 669(a)(1)(B), which is attributable to the amounts treated under section 668(a) as having been received by the beneficiary from a foreign trust created by a U.S. person on the last day of the preceding taxable year.

(5) Fifth, add the amount determined under subparagraph (4) of this paragraph to the beneficiary's tax for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him, computed without inclusion of the accumulation distribution in gross income for that year. The total is the beneficiary's income tax for such year.

(b) *Credit for tax paid by trust.* The income taxes deemed distributed to a beneficiary in the manner described in paragraphs (c) and (d) of § 1.669(a)–2 are included in the beneficiary's gross income for purposes of the computations required by this section. To the extent provided in § 1.669(a)–2, credits for such taxes are allowable to the beneficiary. In the computations under the short-cut throwback method provided in section 669(a)(1)(B), the rules set forth in section 662(b) and § 1.662(b)–1 shall be applied in determining the character, in the hands of the beneficiary, of the amounts, including taxes includible in the distribution or deemed distributed, treated as received by a beneficiary in prior taxable years. For example, if one-fifth of such amounts represents tax-free income, then one-fifth of the amount determined under paragraph (a)(2) of this section shall be treated as tax-free income.

[T.D. 6989, 34 FR 739, Jan. 17, 1969]

§ 1.669(b)–1 Information requirements.

The election of a beneficiary who is a U.S. person to apply the limitations on tax provided in section 669(a) shall not be effective unless the beneficiary, at or before the time the election is made, supplies, in a letter addressed to the district director for the internal revenue district in which the taxpayer files his return (or the Director of International Operations where appropriate), or in a statement attached to his return, the following information with respect to the operation and accounts of the foreign trust created by a U.S. person for each of the preceding taxable years, on the last day of which an amount is deemed distributed under section 666(a):

(a) The gross income of the trust: The gross income should be separated to show the amount of each type of income received by the trust and to identify its source. For example, the beneficiary should list separately, by type (dividends, rents, capital gains, taxable interest, exempt interest, etc.) and source (name and country of payor), each item of income included in the gross income of the trust. For this purpose, the gross income of the trust includes gross income from U.S. sources which is exempt from taxation under section 894.

(b) The amount of tax withheld under section 1441 by the United States on income from sources within the United States.

(c) The amount of the tax paid to each foreign country by the trust.

(d) The expenses of the trust attributable to each type of income disclosed in paragraph (b) of this section, and the general expenses of the trust.

(e) The distributions, if any, made by the trust to the beneficiaries (including those who are not U.S. persons). These distributions should be separated into amounts of income required to be distributed currently within the meaning of section 661(a)(1), and any other amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2).

(f) Any other information which is necessary for the computation of tax on the accumulation distribution as provided in section 669(a).

(g) If the foreign trust created by a U.S. person is less than the entire foreign trust, the information listed in paragraphs (a) through (f) of this section shall also be furnished with respect to that portion of the entire foreign trust which is not a foreign trust created by a U.S. person.

[T.D. 6989, 34 FR 740, Jan. 17, 1969]

§ 1.669(b)–2 Manner of exercising election.

(a) *By whom election is to be made.* Except as otherwise provided in this paragraph, a taxpayer whose tax liability is affected by the election shall make the election provided in section 669(a). In the case of a partnership, or a corporation electing under the provisions of subchapter S, chapter 1 of the Code, the election shall be exercised by the partnership or such corporation.

(b) *Time and manner of making election.* The election under section 669(a) may be made, or revoked, at any time before the expiration of the period provided in section 6501 for assessment of the tax. If an election is revoked, a new election may be made at any time before the expiration of such period. The election (or a revocation of an election) may be made in a letter addressed to the district director of internal revenue for the district in which the taxpayer files his tax return (or the Director of International Operations where appropriate) or may be made in a statement attached to the return. In any case where all the information described in § 1.669(b)–1 is not furnished at or before the time the beneficiary signifies his intention of making an election and by reason thereof an election has not been made, and subsequent thereto, but before the expiration of the period provided in section 6501 for the assessment of the tax, there is furnished the required information not previously furnished, the election will be considered as made at the time such additional information is furnished.

[T.D. 6989, 34 FR 740, Jan. 17, 1969]

UNITRUST ACTUARIAL TABLES APPLICABLE BEFORE MAY 1, 1999

§ 1.664–4A Valuation of charitable remainder interests for which the valuation date is before May 1, 1999.

(a) *Valuation of charitable remainder interests for which the valuation date is* *before January 1, 1952.* There was no provision for the qualification of a charitable remainder unitrust under section 664 until 1969. See § 20.2031–7A(a) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable interest for which the valuation date is before January 1, 1952.

(b) *Valuation of charitable remainder interests for which the valuation date is after December 31, 1951, and before January 1, 1971.* No charitable deduction is allowable for a transfer to a unitrust for which the valuation date is after the effective dates of the Tax Reform Act of 1969 unless the unitrust meets the requirements of section 664. See § 20.2031–7A(b) of this chapter (Estate Tax Regulations) for the determination of the present value of a charitable remainder interest for which the valuation date is after December 31, 1951, and before January 1, 1971.

(c) *Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after December 31, 1970, and before December 1, 1983.* For the determination of the present value of a charitable remainder unitrust for which the valuation date is after December 31, 1970, and before December 1, 1983, see § 20.2031–7A(c) of this chapter (Estate Tax Regulations) and former § 1.664–4(d) (as contained in the 26 CFR part 1 edition revised as of April 1, 1994).

(d) *Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after November 30, 1983, and before May 1, 1989*—(1) *In general.* Except as otherwise provided in paragraph (d)(2) of this section, in the case of transfers made after November 30, 1983, for which the valuation date is before May 1, 1989, the present value of a remainder interest that is dependent on a term of years or the termination of the life of one individual is determined under paragraphs (d)(3) through (d)(6) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under § 1.664–3(a)(1)(v) if the taxable year of the trust were to end on such date. The present value of the remainder interest in the trust is determined by computing the adjusted payout rate (as defined in paragraph (d)(3) of this section) and following the procedure outlined in paragraph (d)(4) or (d)(5) of this section, whichever is applicable. The present value of a remainder interest that is dependent on a term of years is computed under paragraph (d)(4) of this section. The present value of a remainder interest that is dependent on the termination of the life of one individual is computed under paragraph (d)(5) of this section. See paragraph (d)(2) of this section for testamentary transfers for which the valuation date is after November 30, 1983, and before August 9, 1984.

(2) *Rules for determining the present value for testamentary transfers where the decedent dies after November 30, 1983, and before August 9, 1984.* For purposes of section 2055 or 2106, if—

(i) The decedent dies after November 30, 1983, and before August 9, 1984; or

(ii) On December 1, 1983, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after November 30, 1983, without regaining competency to dispose of the decedent's property, or died within 90 days of the date on which the decedent first regained competency, the present value determined under this section of a remainder interest is determined in accordance with paragraph (d)(1) and paragraphs (d)(3) through (d)(6) of this section, or § 1.664–4A(c), at the option of the taxpayer.

(3) *Adjusted payout rate.* The adjusted payout rate is determined by multiplying the fixed percentage described in paragraph (a)(1)(i)(*a*) of § 1.664–3 by the figure in column (2) of Table F(1) which describes the payout sequence of the trust opposite the number in column (1) of Table F(1) which corresponds to the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution shall be made during the taxable year of the trust, see § 1.664–4(a). In the case of a trust having a payout sequence for which no figures have been provided by Table F (1) and in the case of a trust

which determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see § 1.664–4(b).

(4) *Period is a term of years.* If the period described in § 1.664–3(a)(5) is a term of years, the factor which is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in Table D in § 1.664–4(e)(6) that corresponds to the number of years in the term. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (d)(4). For purposes of this section, the term *appropriate valuation date* means the date on which the property is transferred to the trust by the donor except that, for purposes of section 2055 or 2106, it means the date of death unless the alternate valuation date is elected in accordance with section 2032 and the regulations thereunder in which event it means the alternate valuation date. If the adjusted payout rate is greater than 14 percent, see § 1.664–4(b). The application of this paragraph (d)(4) may be illustrated by the following example:

Example. D transfers $100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to D semiannually (on June 30 and December 31) 10 percent of the fair market value of the trust assets as of June 30th for a term of 15 years. The adjusted payout rate is 9.767 percent (10%×0.976731). The present value of the remainder interest is $21,404.90, computed as follows:

Factor at 9.6 percent for 15 years	0.220053
Factor at 9.8 percent for 15 years	.212862
Difference	.007191

9.767% − 9.6 ÷ 0.2% x ÷ .007191

X === .006004

Factor at 9.6 percent for 15 years	0.220053
Less: X	.006004
Interpolated factor	.214049

Present value of remainder interest = $100,000×0.214049 = $21,404.90

(5) *Period is the life of one individual.* If the period described in paragraph (a)(5) of § 1.664–3 is the life of one individual, the factor that is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table E in paragraph (d)(6) of this section opposite the number in column (1) that corresponds to the age of the individual whose life measures the period. For purposes of the computations described in this paragraph (b)(5), the age of an individual is to be taken as the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided for in Table E, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (b)(5). If the adjusted payout rate is greater than 14 percent, see § 1.664–4(b). The application of this paragraph may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers $100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to A at the end of each taxable year of the trust 10 percent of the fair market value of the trust assets as of the beginning of each taxable year of the trust. The adjusted payout rate is 9.091 percent (10 percent×.909091). The present value of the remainder interest is $15,259.00 computed as follows:

Factor at 9 percent at age 50	0.15472
Factor at 9.2 percent at age 50	.15003
Difference	.00469

9.091% − 9%÷0.2%=X÷0.00469

x=0.00213

Factor at 9 percent at age 50	.15472
Less: X	.00213
Interpolated factor	.15259

Present value of remainder interest= $100,000×0.15259=$15,259.00

(6) *Actuarial tables for transfers for which the valuation date is after November 30, 1983, and before May 1, 1989.*

Table D in § 1.664–4(e)(6) and the following tables shall be used in the application of the provisions of this section:

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	2.2%	2.4%	2.6%	2.8%	3.0%
0	.23253	.20635	.18364	.16394	.14683
1	.22196	.19506	.17170	.15139	.13372
2	.22597	.19884	.17523	.15468	.13676
3	.23039	.20304	.17920	.15840	.14024
4	.23503	.20747	.18340	.16237	.14397
5	.23988	.21211	.18783	.16656	.14793
6	.24489	.21693	.19243	.17094	.15207
7	.25004	.22189	.19718	.17546	.15637
8	.25534	.22701	.20209	.18016	.16084
9	.26080	.23230	.20718	.18503	.16549
10	.26640	.23774	.21243	.19008	.17031
11	.27217	.24335	.21786	.19530	.17532
12	.27807	.24911	.22344	.20068	.18049
13	.28407	.25497	.22913	.20618	.18579
14	.29013	.26089	.23489	.21175	.19115
15	.29621	.26684	.24067	.21735	.19655
16	.30229	.27279	.24647	.22296	.20196
17	.30838	.27876	.25228	.22859	.20739
18	.31451	.28477	.25813	.23427	.21287
19	.32070	.29085	.26407	.24003	.21844
20	.32699	.29704	.27012	.24591	.22413
21	.33339	.30335	.27629	.25192	.22996
22	.33991	.30977	.28259	.25807	.23592
23	.34655	.31634	.28904	.26437	.24205
24	.35334	.32306	.29566	.27085	.24836
25	.36031	.32998	.30248	.27754	.25490
26	.36746	.33710	.30952	.28446	.26167
27	.37481	.34443	.31678	.29161	.26869
28	.38236	.35197	.32427	.29901	.27596
29	.39006	.35968	.33194	.30660	.28344
30	.39793	.36757	.33980	.31439	.29113
31	.40594	.37561	.34783	.32237	.29902
32	.41410	.38383	.35605	.33054	.30711
33	.42240	.39220	.36444	.33890	.31541
34	.43084	.40072	.37299	.34744	.32389
35	.43942	.40941	.38172	.35617	.33258
36	.44813	.41824	.39061	.36508	.34146
37	.45696	.42720	.39966	.37416	.35053
38	.46591	.43630	.40885	.38339	.35977
39	.47496	.44552	.41818	.39278	.36917
40	.48412	.45486	.42765	.40232	.37875
41	.49338	.46432	.43725	.41201	.38849
42	.50275	.47391	.44700	.42187	.39840
43	.51221	.48360	.45686	.43186	.40847
44	.52175	.49340	.46685	.44199	.41870
45	.53136	.50327	.47693	.45223	.42905
46	.54104	.51323	.48712	.46259	.43953
47	.55077	.52327	.49739	.47305	.45013
48	.56058	.53339	.50777	.48363	.46087
49	.57043	.54358	.51823	.49432	.47173
50	.58035	.55384	.52879	.50510	.48271
51	.59029	.56415	.53940	.51597	.49379
52	.60027	.57450	.55008	.52692	.50496
53	.61026	.58488	.56080	.53793	.51620
54	.62025	.59528	.57154	.54897	.52750
55	.63022	.60567	.58230	.56004	.53884
56	.64018	.61606	.59306	.57113	.55021
57	.65012	.62644	.60384	.58225	.56163
58	.66004	.63681	.61461	.59337	.57306
59	.66993	.64717	.62538	.60452	.58453
60	.67979	.65751	.63615	.61567	.59602
61	.68963	.66784	.64692	.62683	.60754
62	.69944	.67815	.65769	.63801	.61908
63	.70922	.68844	.66843	.64918	.63063
64	.71893	.69868	.67915	.66032	.64217
65	.72859	.70886	.68982	.67144	.65369
66	.73817	.71897	.70043	.68250	.66517
67	.74766	.72901	.71096	.69350	.67660
68	.75706	.73896	.72142	.70443	.68796
69	.76637	.74882	.73181	.71530	.69928
70	.77559	.75861	.74212	.72610	.71053
71	.78475	.76833	.75237	1.73685	1.72176
72	.79383	.77799	.76257	.74756	.73294
73	.80279	.78753	.77266	.75816	.74403
74	.81158	.79689	.78256	.76858	.75494
75	.82013	.80602	.79223	.77876	.76561
76	.82844	.81488	.80163	.78867	.77599
77	.83648	.82347	.81075	.79829	.78609
78	.84428	.83182	.81961	.80764	.79592
79	.85187	.83994	.82824	.81677	.80552
80	.85927	.84787	.83668	.82569	.81491
81	.86645	.85556	.84487	.83437	.82404
82	.87336	.86299	.85278	.84275	.83288
83	.88003	.87014	.86042	.85084	.84142
84	.88648	.87708	.86782	.85870	.84971
85	.89273	.88381	.87501	.86633	.85778
86	.89868	.89021	.88185	.87360	.86547
87	.90417	.89613	.88818	.88034	.87260
88	.90923	.90158	.89402	.88655	.87917
89	.91396	.90668	.89948	.89237	.88533
90	.91849	.91156	.90471	.89794	.89124
91	.92278	.91620	.90968	.90324	.89686
92	.92673	.92046	.91426	.90812	.90204
93	.93027	.92429	.91837	.91251	.90670
94	.93341	.92768	.92201	.91639	.91082
95	.93612	.93062	.92516	.91976	.91440
96	.93841	.93309	.92782	.92259	.91740
97	.94044	.93529	.93018	.92512	.92009
98	.94223	.93723	.93226	.92733	.92244
99	.94392	.93905	.93421	.92942	.92466
100 ..	.94559	.94086	.93615	.93149	.92685
101 ..	.94709	.94248	.93790	.93334	.92882
102 ..	.94873	.94424	.93979	.93536	.93096
103 ..	.95077	.94645	.94216	.93789	.93365
104 ..	.95278	.94862	.94449	.94037	.93628
105 ..	.95570	.95178	.94787	.94399	.94012
106 ..	.96017	.95662	.95309	.94957	.94607
107 ..	.96616	.96313	.96010	.95709	.95408
108 ..	.97515	.97291	.97067	.96843	.96620
109 ..	.98900	.98800	.98700	.98600	.98500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
0	.13196	.11901	.10774	.09791	.08933
1	.11834	.10493	.09324	.08303	.07410
2	.12113	.10749	.09557	.08514	.07601
3	.12437	.11050	.09835	.08770	.07837

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
4	.12787	.11376	.10138	.09052	.08098
5	.13159	.11725	.10465	.09357	.08382
6	.13549	.12092	.10810	.09680	.08684
7	.13956	.12476	.11171	.10019	.09002
8	.14380	.12877	.11549	.10376	.09337
9	.14822	.13296	.11946	.10751	.09691
10	.15282	.13734	.12361	.11144	.10063
11	.15761	.14190	.12795	.11556	.10454
12	.16257	.14663	.13247	.11986	.10863
13	.16764	.15149	.13711	.12428	.12283
14	.17279	.15643	.14182	.12878	.11712
15	.17798	.16140	.14657	.13331	.12143
16	.18318	.16638	.15133	.13785	.12576
17	.18840	.17138	.15611	.14241	.13010
18	.19367	.17643	.16094	.14702	.13449
19	.19903	.18157	.16586	.15172	.13897
20	.20452	.18685	.17092	.15655	.14358
21	.21014	.19226	.17612	.16153	.14833
22	.21591	.19783	.18146	.16665	.15324
23	.22185	.20356	.18698	.17195	.15832
24	.22798	.20949	.19270	.17746	.16361
25	.23434	.21565	.19866	.18321	.16914
26	.24094	.22207	.20489	.18922	.17494
27	.24780	.22875	.21138	.19551	.18102
28	.25492	.23570	.21814	.20208	.18739
29	.26226	.24288	.22514	.20889	.19400
30	.26982	.25029	.23239	.21596	.20088
31	.27759	.25792	.23985	.22324	.20798
32	.28557	.26577	.24755	.23078	.21533
33	.29377	.27385	.25548	.23855	.22293
34	.30217	.28214	.26364	.24656	.23077
35	.31079	.29065	.27203	.25481	.23887
36	.31961	.29939	.28065	.26330	.24721
37	.32863	.30833	.28950	.27202	.25579
38	.33784	.31747	.29855	.28096	.26460
39	.34722	.32680	.30780	.29011	.27363
40	.35679	.33633	.31727	.29948	.28290
41	.36654	.34606	.32693	.30908	.29239
42	.37648	.35599	.33683	.31890	.30213
43	.38659	.36610	.34691	.32894	.31209
44	.39687	.37640	.35720	.33918	.32227
45	.40728	.38685	.36765	.34961	.33265
46	.41785	.39746	.37828	.36023	.34323
47	.42856	.40823	.38908	.37103	.35400
48	.43941	.41917	.40006	.38202	.36499
49	.45040	.43025	.41121	.39320	.37617
50	.46153	.44149	.42252	.40457	.38756
51	.47277	.45286	.43398	.41609	.39911
52	.48412	.46435	.44558	.42776	.41084
53	.49556	.47595	.45731	.43958	.42272
54	.50707	.48763	.46913	.45151	.43473
55	.51864	.49939	.48104	.46354	.44685
56	.53026	.51121	.49303	.47567	.45908
57	.54192	.52310	.50510	.48789	.47143
58	.55363	.53503	.51723	.50019	.48387
59	.56538	.54703	.52945	.51258	.49642
60	.57717	.55909	.54173	.52506	.50906
61	.58901	.57120	.55408	.53763	.52181
62	.60087	.58336	.56650	.55028	.53466
63	.61277	.59556	.57898	.56300	.54760
64	.62467	.60778	.59149	.57577	.56060
65	.63655	.62000	.60402	.58857	.57365
66	.64842	.63221	.61654	.60139	.58672
67	.66023	.64439	.62905	.61420	.59980
68	.67200	.65653	.64154	.62699	.61289
69	.68373	.66865	.65400	.63978	.62598

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
70	.69541	.68072	.66645	.65257	.63908
71	.70708	.69279	.67890	.66538	.65222
72	.71870	.70484	.69134	.67819	.66538
73	.73025	.71682	.70372	.69095	.67850
74	.74163	.72863	.71595	.70356	.69147
75	.75275	.74019	.72792	.71593	.70421
76	.76360	.75147	.73962	.72802	.71667
77	.77415	.76246	.75102	.73981	.72883
78	.78443	.77318	.76214	.75133	.74073
79	.79448	.78365	.77303	.76261	.75238
80	.80432	.79392	.78371	.77369	.76384
81	.81390	.80393	.79413	.78450	.77504
82	.82317	.81362	.80423	.79499	.78590
83	.83214	.82301	.81402	.80517	.79645
84	.84086	.83214	.82355	.81508	.80674
85	.84935	.84104	.83284	.82476	.81679
86	.85745	.84953	.84172	.83401	.82640
87	.86496	.85741	.84996	.84260	.83533
88	.87189	.86468	.85757	.85054	.84359
89	.87838	.87150	.86471	.85799	.85135
90	.88461	.87806	.87157	.86516	.85881
91	.89055	.88430	.87812	.87200	.86594
92	.89602	.89006	.88416	.87831	.87252
93	.90094	.89524	.88959	.88400	.87846
94	.90530	.89983	.89441	.88904	.88372
95	.90908	.90381	.89359	.89341	.88828
96	.91226	.90716	.90211	.89709	.89212
97	.91510	.91015	.90525	.90038	.89555
98	.91759	.91277	.90800	.90326	.89855
99	.91993	.91524	.91058	.90596	.90137
100	.92225	.91768	.91315	.90865	.90417
101	.92433	.91987	.91544	.91104	.90667
102	.92659	.92225	.91793	.91364	.90938
103	.92943	.92524	.92107	.91692	.91280
104	.93221	.92816	.92413	.92012	.91614
105	.93627	.93244	.92863	.92483	.92105
106	.94257	.93909	.93562	.93217	.92872
107	.95107	.94808	.94509	.94211	.93914
108	.96396	.96173	.95950	.95728	.95505
109	.98400	.98300	.98200	.98100	.98000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
0	.08183	.07527	.06952	.06448	.06005
1	.06629	.05945	.05344	.04817	.04354
2	.06801	.06098	.05481	.04939	.04460
3	.07017	.06297	.05663	.05104	.04611
4	.07259	.06520	.05868	.05294	.04786
5	.07523	.06765	.06096	.05505	.04982
6	.07805	.07029	.06342	.05734	.05195
7	.08103	.07307	.06603	.05978	.05423
8	.08418	.07603	.06880	.06238	.05666
9	.08752	.07917	.07175	.06516	.05928
10	.09103	.08249	.07488	.06811	.06206
11	.09473	.08600	.07820	.07125	.06503
12	.09861	.08968	.08169	.07456	.06817

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
13	.10261	.09348	.08530	.07799	.07142
14	.10669	.09735	.08899	.08148	.07474
15	.11080	.10126	.09269	.08500	.07808
16	.11491	.10516	.09640	.08852	.08142
17	.11903	.10908	.10012	.09204	.08475
18	.12321	.11304	.10387	.09560	.08812
19	.12747	.11709	.10771	.09923	.09156
20	.13186	.12126	.11168	.10300	.09513
21	.13639	.12558	.11578	.10690	.09883
22	.14108	.13005	.12004	.11094	.10268
23	.14594	.13469	.12446	.11516	.10669
24	.15101	.13954	.12910	.11958	.11091
25	.15632	.14464	.13398	.12426	.11537
26	.16191	.15001	.13914	.12920	.12011
27	.16778	.15567	.14459	.13444	.12514
28	.17394	.16162	.15032	.13997	.13046
29	.18035	.16782	.15632	.14575	.13604
30	.18702	.17429	.16259	.15181	.14189
31	.19393	.18100	.16909	.15811	.14799
32	.20109	.18797	.17586	.16468	.15436
33	.20851	.19520	.18290	.17152	.16100
34	.21618	.20268	.19018	.17861	.16789
35	.22411	.21043	.19775	.18599	.17508
36	.23228	.21844	.20558	.19363	.18253
37	.24071	.22670	.21367	.20154	.19026
38	.24938	.23521	.22201	.20971	.19825
39	.25827	.24396	.23060	.21814	.20650
40	.26741	.25295	.23945	.22682	.21502
41	.27679	.26220	.24855	.23577	.22381
42	.28642	.27172	.25793	.24501	.23289
43	.29629	.28147	.26756	.25450	.24224
44	.30639	.29147	.27745	.26426	.25186
45	.31669	.30169	.28756	.27426	.26173
46	.32722	.31213	.29791	.28450	.27185
47	.33795	.32280	.30849	.29498	.28222
48	.34890	.33370	.31932	.30573	.29287
49	.36007	.34482	.33039	.31672	.30377
50	.37144	.35617	.34170	.32797	.31494
51	.38301	.36773	.35322	.33944	.32635
52	.39476	.37948	.36495	.35113	.33799
53	.40668	.39141	.37688	.36304	.34986
54	.41874	.40350	.38897	.37512	.36191
55	.43093	.41574	.40123	.38739	.37416
56	.44324	.42811	.41364	.39980	.38657
57	.45568	.44062	.42620	.41240	.39918
58	.46823	.45325	.43890	.42514	.41194
59	.48091	.46603	.45175	.43805	.42489
60	.49370	.47893	.46475	.45112	.43802
61	.50661	.49198	.47790	.46436	.45133
62	.51963	.50515	.49120	.47776	.46481
63	.53275	.51844	.50463	.49131	.47846
64	.54596	.53182	.51817	.50498	.49225
65	.55922	.54528	.53180	.51877	.50616
66	.57253	.55880	.54551	.53264	.52018
67	.58586	.57235	.55926	.54657	.53427
68	.59921	.58594	.57306	.56057	.54845
69	.61258	.59956	.58692	.57463	.56270
70	.62597	.61322	.60082	.58877	.57704
71	.63941	.62695	.61481	.60300	.59149
72	.65289	.64073	.62887	.61731	.60605
73	.66635	.65449	.64293	.63165	.62064
74	.67976	.66814	.65688	.64588	.63514
75	.69275	.68156	.67061	.65990	.64944
76	.70557	.69470	.68407	.67366	.66348
77	.71809	.70756	.69724	.68714	.67724
78	.73033	.72014	.71015	.70036	.69075
79	.74235	.73251	.72284	.71336	.70405
80	.75417	.74468	.73535	.72619	.71718
81	.76573	.75659	.74759	.73875	.73006
82	.77696	.76816	.75951	.75099	.74261
83	.78787	.77942	.77110	.76291	.75484
84	.79852	.79042	.78243	.77457	.76681
85	.80893	.80118	.79353	.78599	.77856
86	.81889	.81148	.80417	.79695	.78983
87	.82816	.82107	.81408	.80716	.80034
88	.83673	.82994	.82324	.81662	.81007
89	.84478	.83828	.83186	.82551	.81923
90	.85253	.84632	.84018	.83410	.82808
91	.85994	.85401	.84813	.84232	.83656
92	.86679	.86111	.85549	.84993	.84441
93	.87296	.86752	.86213	.85679	.85150
94	.87844	.87321	.86803	.86289	.85780
95	.88319	.87815	.87314	.86818	.86327
96	.88719	.88230	.87745	.87264	.86787
97	.89076	.88601	.88129	.87661	.87197
98	.89388	.88925	.88465	.88009	.87556
99	.89682	.89230	.88781	.88336	.87894
100 ..	.89973	.89533	.89095	.88660	.88228
101 ..	.90233	.89802	.89374	.88948	.88526
102 ..	.90515	.90094	.89676	.89260	.88848
103 ..	.90871	.90464	.90059	.89656	.89256
104 ..	.91217	.90823	.90431	.90040	.89652
105 ..	.91729	.91354	.90981	.90610	.90240
106 ..	.92529	.92187	.91846	.91507	.91169
107 ..	.93617	.93322	.93027	.92732	.92439
108 ..	.95283	.95062	.94840	.94619	.94398
109 ..	.97900	.97800	.97700	.97600	.97500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
0	.05615	.05272	.04969	.04701	.04464
1	.03945	.03585	.03268	.02986	.02737
2	.04039	.03667	.03337	.03046	.02787
3	.04176	.03791	.03450	.03147	.02879
4	.04336	.03938	.03585	.03272	.02993
5	.04518	.04107	.03741	.03416	.03127
6	.04717	.04292	.03914	.03577	.03276
7	.04929	.04490	.04099	.03750	.03438
8	.05158	.04704	.04300	.03938	.03615
9	.05404	.04936	.04518	.04143	.03808
10	.05666	.05183	.04751	.04364	.04016
11	.05947	.05449	.05003	.04602	.04242
12	.06245	.05731	.05271	.04856	.04484
13	.06554	.06025	.05549	.05121	.04735
14	.06869	.06324	.05834	.05391	.04992
15	.07186	.06625	.06119	.05662	.05250
16	.07502	.06924	.06403	.05931	.05504
17	.07817	.07223	.06685	.06199	.05757
18	.08136	.07524	.06970	.06468	.06012
19	.08462	.07832	.07261	.06743	.06272
20	.08800	.08152	.07564	.07029	.06542
21	.09151	.08485	.07879	.07327	.06824

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
22	.09516	.08831	.08207	.07638	.07119
23	.09897	.09193	.08551	.07964	.07428
24	.10299	.09576	.08915	.08310	.07756
25	.10725	.09982	.09302	.08679	.08108
26	.11179	.10416	.09717	.09075	.08486
27	.11661	.10878	.10160	.09500	.08892
28	.12173	.11370	.10632	.09953	.09328
29	.12710	.11888	.11130	.10432	.09788
30	.13276	.12433	.11656	.10938	.10276
31	.13865	.13002	.12205	.11469	.10787
32	.14482	.13599	.12783	.12026	.11326
33	.15126	.14223	.13387	.12612	.11892
34	.15796	.14874	.14018	.13223	.12485
35	.16494	.15553	.14678	.13864	.13107
36	.17221	.16260	.15366	.14533	.13757
37	.17975	.16996	.16082	.15231	.14435
38	.18756	.17758	.16826	.15955	.15142
39	.19563	.18547	.17597	.16708	.15875
40	.20397	.19364	.18395	.17488	.16638
41	.21259	.20209	.19223	.18298	.17430
42	.22152	.21084	.20082	.19140	.18254
43	.23071	.21988	.20969	.20010	.19107
44	.24019	.22920	.21885	.20910	.19991
45	.24992	.23878	.22828	.21837	.20902
46	.25991	.24864	.23799	.22793	.21842
47	.27016	.25876	.24798	.23777	.22812
48	.28070	.26918	.25826	.24792	.23812
49	.29150	.27987	.26883	.25837	.24843
50	.30258	.29084	.27970	.26911	.25905
51	.31391	.30208	.29084	.28014	.26996
52	.32548	.31358	.30224	.29144	.28115
53	.33729	.32532	.31390	.30302	.29263
54	.34931	.33728	.32579	.31482	.30434
55	.36152	.34945	.33790	.32686	.31631
56	.37392	.36181	.35022	.33912	.32850
57	.38652	.37438	.36276	.35162	.34093
58	.39929	.38715	.37550	.36432	.35359
59	.41226	.40013	.38847	.37727	.36650
60	.42542	.41331	.40165	.39044	.37965
61	.43878	.42670	.41506	.40386	.39306
62	.45233	.44029	.42869	.41750	.40671
63	.46606	.45409	.44253	.43138	.42060
64	.47994	.46805	.45656	.44545	.43471
65	.49397	.48217	.47076	.45971	.44902
66	.50811	.49642	.48510	.47413	.46350
67	.52235	.51079	.49957	.48869	.47814
68	.53668	.52525	.51416	.50339	.49293
69	.55110	.53983	.52888	.51823	.50788
70	.56563	.55453	.54373	.53322	.52299
71	.58029	.56938	.55875	.54839	.53830
72	.59507	.58436	.57392	.56374	.55380
73	.60990	.59941	.58917	.57918	.56942
74	.62465	.61439	.60437	.59458	.58502
75	.63920	.62919	.61940	.60983	.60046
76	.65351	.64375	.63419	.62484	.61568
77	.66755	.65804	.64873	.63961	.63066
78	.68133	.67209	.66303	.65414	.64542
79	.69492	.68595	.67714	.66850	.66001
80	.70834	.69965	.69111	.68272	.67448
81	.72151	.71311	.70484	.69671	.68872
82	.73436	.72624	.71825	.71039	.70265
83	.74689	.73906	.73135	.72376	.71627
84	.75917	.75163	.74421	.73688	.72967
85	.77122	.76398	.75685	.74980	.74286
86	.78280	.77586	.76901	.76224	.75556
87	.79359	.78693	.78036	.77386	.76744
88	.80360	.79720	.79088	.78463	.77846
89	.81302	.80688	.80081	.79480	.78886
90	.82213	.81624	.81041	.80465	.79894
91	.83086	.82522	.81963	.81410	.80862
92	.83895	.83354	.82818	.82287	.81762
93	.84626	.84106	.83591	.83081	.82575
94	.85275	.84774	.84278	.83787	.83299
95	.85839	.85355	.84876	.84400	.83929
96	.86313	.85844	.85378	.84916	.84458
97	.86737	.86280	.85826	.85377	.84930
98	.87107	.86661	.86218	.85779	.85343
99	.87455	.87019	.86586	.86157	.85730
100 ..	.87800	.87374	.86951	.86532	.86115
101 ..	.88106	.87689	.87275	.86863	.86455
102 ..	.88437	.88030	.87625	.87222	.86822
103 ..	.88858	.88463	.88070	.87679	.87290
104 ..	.89266	.88882	.88500	.88120	.87741
105 ..	.89872	.89506	.89141	.88778	.88417
106 ..	.90832	.90496	.90161	.89828	.89496
107 ..	.92146	.91854	.91562	.91271	.90981
108 ..	.94177	.93956	.93736	.93516	.93296
109 ..	.97400	.97300	.97200	.97100	.97000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted Payout Rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
0	.04253	.04066	.03899	.03751	.03618
1	.02516	.02320	.02145	.01989	.01850
2	.02557	.02353	.02171	.02008	.01862
3	.02640	.02427	.02237	.02067	.01915
4	.02744	.02523	.02325	.02147	.01988
5	.02868	.02638	.02431	.02246	.02080
6	.03008	.02767	.02552	.02359	.02185
7	.03159	.02909	.02685	.02483	.02302
8	.03325	.03065	.02831	.02621	.02432
9	.03507	.03236	.02993	.02774	.02576
10	.03704	.03423	.03170	.02941	.02735
11	.03918	.03626	.03363	.03125	.02910
12	.04148	.03845	.03571	.03323	.03099
13	.04387	.04073	.03788	.03531	.03297
14	.04632	.04305	.04010	.03742	.03499
15	.04876	.04538	.04231	.03953	.03699
16	.05118	.04767	.04449	.04159	.03896
17	.05357	.04994	.04663	.04362	.04088
18	.05598	.05221	.04878	.04565	.04280
19	.05843	.05453	.05097	.04772	.04476
20	.06099	.05694	.05325	.04988	.04679
21	.06365	.05946	.05564	.05213	.04893
22	.06644	.06210	.05813	.05449	.05116
23	.06937	.06488	.06076	.05699	.05352
24	.07249	.06784	.06357	.05965	.05605
25	.07584	.07103	.06660	.06254	.05879
26	.07945	.07447	.06989	.06567	.06178
27	.08334	.07819	.07345	.06907	.06503
28	.08751	.08219	.07729	.07275	.06856
29	.09194	.08645	.98137	.07667	.07233
30	.09663	.09096	.08572	.08086	.07635

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted Payout Rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
31	.10156	.09572	.09030	.08527	.08060
32	.10677	.10074	.09515	.08995	.08512
33	.11224	.10604	.10027	.09490	.08990
34	.11798	.11159	.10564	.10010	.09494
35	.12401	.11744	.11131	.10560	.10026
36	.13033	.12357	.11727	.11137	.10586
37	.13693	.12999	.12350	.11743	.11175
38	.14380	.13668	.13002	.12377	.11791
39	.15096	.14366	.13681	.13038	.12436
40	.15841	.15092	.14390	.13729	.13109
41	.16615	.15848	.15128	.14450	.13812
42	.17421	.16637	.15899	.15204	.14549
43	.18257	.17456	.16700	.15988	.15316
44	.19124	.18306	.17533	.16804	.16115
45	.20018	.19184	.18395	.17649	.16943
46	.20943	.20092	.19287	.18524	.17802
47	.21897	.21030	.20209	.19431	.18692
48	.22883	.22001	.21165	.20371	.19616
49	.23900	.23004	.22152	.21343	.20573
50	.24948	.24039	.23173	.22349	.21565
51	.26027	.25104	.24225	.23387	.22589
52	.27135	.26200	.25308	.24457	.23645
53	.28271	.27325	.26421	.25558	.24733
54	.29433	.28476	.27561	.26686	.25848
55	.30621	.29654	.28728	.27842	.26993
56	.31832	.30856	.29921	.29025	.28165
57	.33068	.32085	.31142	.30236	.29367
58	.34329	.33339	.32388	.31474	.30595
59	.35615	.34620	.33662	.32741	.31855
60	.36927	.35927	.34964	.34037	.33143
61	.38265	.37262	.36295	.35362	.34463
62	.39630	.38625	.37655	.36718	.35814
63	.41020	.40014	.39043	.38104	.37196
64	.42432	.41428	.40456	.39516	.38606
65	.43866	.42864	.41893	.40953	.40042
66	.45320	.44321	.43353	.42414	.41503
67	.46790	.45796	.44832	.43896	.42987
68	.48277	.47289	.46330	.45398	.44492
69	.49781	.48802	.47849	.46923	.46021
70	.51303	.50333	.49389	.48470	.47574
71	.52847	.51888	.50954	.50044	.49156
72	.54412	.53466	.52544	.51644	.50766
73	.55990	.55059	.54151	.52363	.52396
74	.57566	.56652	.55758	.54885	.54030
75	.59129	.58232	.57354	.56496	.55655
76	.60671	.59792	.58932	.58089	.57263
77	.62189	.61330	.60487	.59661	.58851
78	.63687	.62847	.62024	.61215	.60422
79	.65168	.64349	.63546	.62756	.61981
80	.66637	.65841	.65058	.64289	.63532
81	.68085	.67312	.66551	.65802	.65066
82	.69503	.68753	.68014	.67287	.66571
83	.70890	.70164	.69448	.68743	.68048
84	.72255	.71553	.70861	.70179	.69506
85	.73600	.72924	.72257	.71598	.70948
86	.74897	.7446	.73693	.72969	.72342
87	.76109	.75483	.74864	.74252	.73647
88	.77235	.76631	.76035	.75445	.74862
89	.78298	.77717	.77142	.76573	.76011
90	.79329	.78770	.78217	.77669	.77127
91	.80320	.79783	.79252	.78725	.78204
92	.81241	.80725	.80214	.79708	.79206
93	.82074	.81578	.81086	.80598	.80115
94	.82816	.82337	.81862	.81391	.80924
95	.83461	.82997	.82537	.82081	.81629
96	.84003	.83552	.82105	.82661	.82221
97	.84487	.84048	.83612	.82179	.82750
98	.84910	.84481	.84054	.83631	.83211
99	.85307	.84887	.84469	.84055	.83644
100 ..	.85701	.85290	.84882	.84476	.84073
101 ..	.86049	.85645	.85244	.84846	.84451
102 ..	.86424	.86029	.85637	.85247	.84859
103 ..	.86904	.86520	.86138	.85758	.85381
104 ..	.87365	.86991	.86619	.86249	.85880
105 ..	.88058	.87700	.87343	.86988	.86635
106 ..	.89165	.88835	.88506	.88179	.87852
107 ..	.90692	.90404	.90116	.89829	.89542
108 ..	.93077	.92858	.92639	.92420	.92201
109 ..	.96900	.96800	.96700	.96600	.96500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03499	.03392	.03296	.03209	.03130
1	.01725	.01613	.01513	.01422	.01340
2	.01732	.01615	.01509	.01414	.01329
3	.01778	.01656	.01545	.01446	.01356
4	.01846	.01717	.01601	.01497	.01402
5	.01930	.01796	.01674	.01574	.01465
6	.02029	.01888	.01761	.01645	.01541
7	.02138	.01991	.01857	.01736	.01627
8	.02261	.02106	.01966	.01839	.01724
9	.02397	.02236	.02089	.01956	.01835
10	.02548	.02379	.02225	.02086	.01959
11	.02715	.02538	.02377	.02231	.02098
12	.02895	.02710	.02542	.02389	.02250
13	.03085	.02892	.02716	.02556	.02410
14	.03278	.03076	.02893	.02725	.02572
15	.03469	.03259	.03067	.02892	.02732
16	.03656	.03437	.03237	.03054	.02886
17	.03938	.03610	.03401	.03210	.03035
18	.04020	.03782	.03564	.03364	.03181
19	.04204	.03956	.03729	.03520	.03328
20	.04397	.04138	.03901	.03683	.03483
21	.04599	.04329	.04081	.03853	.03644
22	.04810	.04529	.04270	.04032	.03813
23	.05033	.04740	.04470	.04222	.03992
24	.05273	.04968	.04686	.04427	.04187
25	.05534	.05216	.04922	.04651	.04400
26	.05819	.05488	.05182	.04898	.04636
27	.06130	.05785	.05466	.05170	.04896
28	.06468	.06109	.05777	.05468	.05182
29	.06830	.06457	.06110	.05789	.05490
30	.07217	.06829	.06469	.06134	.05822
31	.07627	.07224	.06849	.06500	.06174
32	.08062	.07644	.07254	.06891	.06552
33	.08524	.08090	.07686	.07308	.06955
34	.09012	.08562	.08142	.07749	.07382
35	.09528	.09062	.08626	.08218	.07836
36	.10071	.09589	.09137	.08714	.08317
37	.10643	.10144	.09676	.09237	.08825
38	.11242	.10727	.10243	.09788	.09361
39	.11869	.11337	.10837	.10366	.09923

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
40	.12526	.11977	.11460	.10973	.10514
41	.13212	.12646	.12113	.11609	.11135
42	.13931	.13349	.12799	.12279	.11789
43	.14681	.14082	.13515	.12980	.12473
44	.15463	.14847	.14264	.13712	.13189
45	.16274	.15642	.15042	.14474	.13935
46	.17117	.16468	.15853	.15268	.14713
47	.17991	.17326	.16694	.16094	.15523
48	.18900	.18219	.17571	.16955	.16368
49	.19841	.19145	.18481	.17850	.17248
50	.20818	.20106	.19428	.18781	.18163
51	.21827	.21101	.20407	.19745	.19113
52	.22869	.22129	.21421	.20745	.20098
53	.23944	.23190	.22468	.21778	.21117
54	.25047	.24280	.23545	.22841	.22167
55	.26180	.25400	.24653	.23936	.23249
56	.27341	.26550	.25790	.25061	.24361
57	.28532	.27729	.26959	.26218	.25505
58	.29751	.28938	.28157	.27405	.26681
59	.31001	.30180	.29388	.28626	.27892
60	.32282	.31452	.30652	.29880	.29136
61	.33595	.32758	.31950	.31169	.30416
62	.34941	.34097	.33282	.32494	.31733
63	.36318	.35469	.34648	.33854	.33085
64	.37725	.36872	.36046	.35246	.34472
65	.39159	.38304	.37474	.36670	.35891
66	.40620	.39763	.38931	.38124	.37340
67	.42104	.41247	.40414	.39605	.38819
68	.43611	.42755	.41923	.41113	.40326
69	.45144	.44290	.43459	.42650	.41863
70	.46702	.45852	.45025	.44218	.43432
71	.48291	.47447	.46623	.45820	.45037
72	.49909	.49072	.48255	.47458	.46679
73	.51549	.50721	.49912	.49912	.48349
74	.53195	.52377	.51578	.50796	.50031
75	.54832	.54027	.53238	.52466	.51710
76	.56454	.55661	.54884	.54123	.53377
77	.58057	.57278	.56514	.55765	.55030
78	.59644	.58879	.58129	.58393	.56670
79	.61219	.60471	.59736	.59013	.58304
80	.62788	.62057	.61338	.60632	.59936
81	.64341	.63628	.62926	.62236	.61556
82	.65866	.65172	.64488	.63815	.63151
83	.67364	.66689	.66024	.65369	.64723
84	.68843	.68189	.67544	.66907	.66279
85	.70307	.69674	.69050	.68433	.67825
86	.71723	.71112	.70508	.69912	.69323
87	.73050	.72460	.71877	.71300	.70731
88	.74285	.73715	.73151	.72593	.72042
89	.75454	.74903	.74358	.73819	.73286
90	.76591	.76060	.75534	.75014	.74499
91	.77688	.77176	.76670	.76169	.75672
92	.78709	.78217	.77729	.77245	.76766
93	.79635	.79160	.78690	.78223	.77761
94	.80461	.80002	.79547	.79096	.78648
95	.81180	.80735	.80394	.79856	.79421
96	.81784	.81351	.80921	.80494	.80071
97	.82324	.81901	.81481	.81065	.80651
98	.82794	.82380	.81969	.81562	.81157
99	.83235	.82830	.83427	.82028	.81631
100 ..	.83674	.83276	.82882	.82490	.82101
101 ..	.84058	.83668	.83280	.82895	.82512
102 ..	.84474	.84091	.83710	.83332	.82956
103 ..	.85006	.84633	.84262	.83893	.83526
104 ..	.85514	.85150	.84787	.84427	.84068
105 ..	.86284	.85934	.85585	.85239	.84893
106 ..	.87527	.87204	.86881	.86559	.86239
107 ..	.89257	.88972	.88688	.88404	.88121
108 ..	.91983	.91765	.91547	.91330	.91113
109 ..	.96400	.96300	.96200	.96100	.96000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
0	.03059	.02995	.02936	.02882	.02833
1	.01267	.01200	.01139	.01084	.01033
2	.01251	.01181	.01117	.01059	.01006
3	.01274	.01200	.01133	.01072	.01016
4	.01316	.01239	.01168	.01103	.01044
5	.01375	.01293	.01218	.01150	.01088
6	.01446	.01360	.01281	.01209	.01144
7	.01527	.01436	.01353	.01277	.01208
8	.01619	.01523	.01436	.01356	.01283
9	.01725	.01624	.01532	.01448	.01370
10	.01843	.01737	.01640	.01551	.01470
11	.01976	.01865	.01763	.01669	.01583
12	.02122	.02005	.01898	.01800	.01709
13	.02276	.02153	.02041	.01937	.01842
14	.02432	.02303	.02185	.02077	.01977
15	.02585	.02451	.02327	.02213	.02108
16	.02732	.02591	.02462	.02342	.02232
17	.02874	.02726	.02590	.02465	.02349
18	.03013	.02858	.02715	.02584	.02462
19	.03152	.02990	.02841	.02703	.02575
20	.03298	.03128	.02971	.02826	.02692
21	.03451	.03272	.03108	.02956	.02815
22	.03611	.03424	.03251	.03091	.02944
23	.03781	.03585	.03404	.03236	.03081
24	.03965	.03760	.03570	.03393	.03230
25	.04168	.03953	.03753	.03568	.03396
26	.04393	.04168	.03958	.03764	.03583
27	.04642	.04406	.04186	.03982	.03792
28	.04916	.04669	.04439	.04224	.04025
29	.05212	.04953	.04712	.04487	.04277
30	.05531	.05260	.05008	.04772	.04552
31	.05871	.05588	.05324	.05077	.04846
32	.06236	.05940	.05663	.05405	.05163
33	.06625	.06316	.06027	.05756	.05502
34	.07038	.06716	.06414	.06131	.05865
35	.07478	.07142	.06827	.06531	.06253
36	.07944	.07595	.07266	.06957	.06667
37	.08438	.08074	.07732	.07410	.07106
38	.08958	.08580	.08223	.07888	.07571
39	.09506	.09112	.08742	.08392	.08061
40	.10081	.09673	.09288	.08924	.08580
41	.10687	.10263	.09863	.09484	.09126
42	.11325	.10886	.10471	.10078	.09705
43	.11993	.11539	.11109	.10701	.10314
44	.12694	.12224	.11779	.11356	.10955
45	.13424	.12939	.12478	.12040	.11624
46	.14186	.13686	.13210	.12757	.12326
47	.14980	.14464	.13973	.13505	.13059
48	.15810	.15278	.14772	.14289	.13828

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
49	.16674	.16127	.15605	.15107	.14631
50	.17574	.17012	.16475	.15962	.15472
51	.18510	.17932	.17381	.16853	.16348
52	.19480	.18888	.18322	.17779	.17260
53	.20484	.19878	.19298	.18741	.18208
54	.21520	.20901	.20306	.19735	.19188
55	.22589	.21955	.21347	.20763	.20202
56	.23688	.23041	.22420	.21822	.21248
57	.24820	.24161	.23527	.22917	.22329
58	.25984	.25313	.24667	.24044	.23444
59	.27184	.26501	.25843	.25209	.24596
60	.28417	.27724	.27055	.26409	.25786
61	.29688	.28985	.28306	.27650	.27015
62	.30996	.30284	.29596	.28929	.28285
63	.32341	.31621	.30924	.30249	.29595
64	.33721	.32994	.32289	.31605	.30943
65	.35134	.34401	.33689	.32999	.32329
66	.36580	.35841	.35124	.34427	.33750
67	.38055	.37312	.36590	.35889	.35206
68	.39559	.38814	.38089	.37383	.36696
69	.41096	.40349	.39622	.38913	.38222
70	.42665	.41918	.41190	.40480	.39787
71	.44273	.43527	.42799	.42089	.41395
72	.45919	.45176	.44450	.43741	.43049
73	.47594	.46856	.46134	.45428	.44738
74	.49283	.48550	.47834	.47132	.46446
75	.50969	.50244	.49534	.48838	.48157
76	.52646	.51929	.51226	.50537	.49862
77	.54309	.53601	.52907	.52226	.51558
78	.55960	.55263	.54579	.53907	.53247
79	.57606	.56921	.56248	.55586	.54935
80	.59253	.58580	.57919	.57269	.56629
81	.60887	.60229	.59581	.58943	.58315
82	.62498	.61855	.61221	.60597	.59982
83	.64086	.63459	.62840	.62230	.61629
84	.65660	.65049	.64447	.63852	.63266
85	.67224	.66631	.66046	.65468	.64898
86	.68742	.68167	.67600	.67040	.66486
87	.70168	.69611	.69061	.68518	.67980
88	.71497	.70958	.70425	.69897	.69376
89	.72758	.72236	.71720	.71208	.70702
90	.73989	.73484	.72985	.72490	.72000
91	.75180	.74693	.74210	.73732	.73259
92	.76292	.75821	.75355	.74894	.74436
93	.77302	.76848	.76397	.75951	.75508
94	.78204	.77764	.77328	.76895	.76466
95	.78991	.78563	.78139	.77719	.77302
96	.79651	.79234	.78821	.78411	.78003
97	.80241	.79834	.79430	.79029	.78630
98	.80755	.80356	.79960	.79567	.79176
99	.81236	.80845	.80456	.80071	.79687
100 ..	.81715	.81331	.80949	.80571	.80195
101 ..	.82132	.81754	.81379	.81006	.80636
102 ..	.82582	.82211	.81842	.81476	.81111
103 ..	.83162	.82799	.82439	.82080	.81724
104 ..	.83711	.83356	.83003	.82652	.82302
105 ..	.84550	.84208	.83867	.83528	.83191
106 ..	.85920	.85602	.85285	.84969	.84655
107 ..	.87839	.87558	.87277	.86997	.86718
108 ..	.90896	.90679	.90463	.90246	.90030
109 ..	.95900	.95800	.95700	.95600	.95500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout Rate				
	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02788	.02747	.02709	.02673	.02641
1	.00987	.00945	.00906	.00871	.00838
2	.00957	.00913	.00872	.00835	.00800
3	.00965	.00918	.00875	.00836	.00799
4	.00991	.00941	.00896	.00854	.00815
5	.01031	.00979	.00931	.00887	.00846
6	.01084	.01028	.00978	.00931	.00888
7	.01144	.01086	.01032	.00983	.00937
8	.01216	.01154	.01097	.01044	.00996
9	.01299	.01234	.01174	.01118	.01067
10	.01395	.01326	.01262	.01204	.01149
11	.01504	.01432	.01364	.01302	.01245
12	.01626	.01549	.01478	.01413	.01352
13	.01755	.01674	.01599	.01530	.01466
14	.01885	.01800	.01721	.01648	.01581
15	.02011	.01922	.01839	.01762	.01691
16	.02130	.02036	.01949	.01869	.01794
17	.02243	.02144	.02052	.01967	.01888
18	.02350	.02246	.02150	.02061	.01978
19	.02457	.02348	.02247	.02153	.02065
20	.02569	.02454	.02347	.02248	.02156
21	.02685	.02564	.02452	.02347	.02250
22	.02806	.02679	.02561	.02451	.02348
23	.02936	.02802	.02677	.02561	.02453
24	.03078	.02937	.02805	.02683	.02569
25	.03236	.03087	.02949	.02820	.02699
26	.03415	.03258	.03112	.02975	.02848
27	.03615	.03450	.03295	.03151	.03017
28	.03838	.03664	.03502	.03350	.03208
29	.04081	.03898	.03727	.03567	.03416
30	.04346	.04154	.03973	.03804	.03646
31	.04630	.04427	.04237	.04059	.03892
32	.04936	.04723	.04523	.04335	.04159
33	.05264	.05041	.04831	.04633	.04448
34	.05615	.05381	.05160	.04952	.04757
35	.05992	.05746	.05514	.05296	.05090
36	.06393	.06135	.05892	.05663	.05447
37	.06820	.06550	.06295	.06055	.05828
38	.07272	.06990	.06723	.06471	.06233
39	.07749	.07454	.07175	.06912	.06662
40	.08254	.07946	.07655	.07379	.07117
41	.08787	.08466	.08162	.07073	.07599
42	.09352	.09018	.08700	.08399	.08112
43	.09947	.09599	.09268	.08953	.08654
44	.10573	.10211	.09866	.09539	.09227
45	.11229	.10852	.10494	.10152	.09827
46	.11916	.11525	.11153	.10798	.10459
47	.12634	.12229	.11843	.11474	.11122
48	.13388	.12969	.12568	.12186	.11820
49	.14177	.13743	.13329	.12932	.12553
50	.15003	.14555	.14126	.13716	.13322
51	.15865	.15402	.14959	.14534	.14127
52	.16763	.16286	.15828	.15390	.14969
53	.17696	.17205	.16734	.16281	.15847
54	.18662	.18157	.17672	.17206	.16758
55	.19662	.19144	.18645	.18165	.17703
56	.20695	.20163	.19651	.19157	.18682
57	.21763	.21218	.20693	.20186	.19698
58	.22865	.22307	.21769	.21250	.20749
59	.24005	.23435	.22885	.22353	.21839
60	.25183	.24601	.24038	.23494	.22969
61	.26401	.25808	.25234	.24678	.24141
62	.27661	.27056	.26471	.25905	.25356
63	.28961	.28347	.27752	.27175	.26615
64	.30300	.29677	.29072	.28486	.27916
65	.31678	.31046	.30433	.29837	.29259

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout Rate				
	9.2%	9.4%	9.6%	9.8%	10.0%
66	.33093	.32454	.31832	.31228	.30641
67	.34542	.33897	.33268	.32657	.32062
68	.36027	.35376	.34742	.34124	.33522
69	.37550	.36894	.36255	.35632	.35024
70	.39111	.38452	.37809	.37182	.36570
71	.40719	.40058	.39412	.38782	.38166
72	.42372	.41710	.41064	.40432	.39814
73	.44062	.43402	.42756	.42124	.41506
74	.45774	.45116	.44471	.43840	.43223
75	.47489	.46834	.46193	.45565	.44949
76	.49199	.48550	.47913	.47288	.46675
77	.50902	.50258	.49626	.49006	.48397
78	.52598	.51962	.51336	.50721	.50117
79	.54295	.53667	.53049	.52441	.51843
80	.55999	.55380	.54771	.54171	.53581
81	.57697	.57088	.56489	.55899	.55317
82	.59375	.58778	.58190	.57610	.57039
83	.61036	.60451	.59875	.59306	.58746
84	.62687	.62116	.61553	.60997	.60448
85	.64335	.63779	.63230	.62688	.62152
86	.65939	.65398	.64864	.64337	.63816
87	.67449	.66924	.66405	.65892	.65384
88	.68860	.68350	.67845	.67346	.66852
89	.70202	.69706	.69216	.68731	.68250
90	.71515	.71035	.70559	.70088	.69622
91	.72790	.72325	.71865	.71409	.70957
92	.73982	.73533	.73087	.72646	.72208
93	.75069	.74634	.74202	.73774	.73350
94	.76040	.75618	.75199	.74784	.74372
95	.76888	.76477	.76070	.75666	.75265
96	.77599	.77199	.76801	.76406	.76014
97	.78235	.77843	.77454	.77067	.76684
98	.78789	.78404	.78022	.77642	.77266
99	.79307	.78929	.78554	.78181	.77811
100 ..	.79821	.79450	.79081	.78715	.78351
101 ..	.80268	.79902	.79539	.79178	.78819
102 ..	.80749	.80389	.80031	.79676	.79322
103 ..	.81370	.81018	.80668	.80319	.79973
104 ..	.81955	.81609	.81265	.80923	.80582
105 ..	.82855	.82520	.82187	.81856	.81526
106 ..	.84341	.84029	.83718	.83408	.83099
107 ..	.86439	.86162	.85884	.85608	.85332
108 ..	.89815	.89599	.89384	.89169	.88955
109 ..	.95400	.95300	.95200	.95100	.95000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
0	.02610	.02582	.02556	.02531	.02508
1	.00807	.00779	.00753	.00729	.00707
2	.00769	.00739	.00712	.00686	.00663
3	.00766	.00735	.00706	.00679	.00654
4	.00780	.00747	.00716	.00688	.00662
5	.00808	.00773	.00741	.00711	.00683
6	.00848	.00811	.00776	.00744	.00715
7	.00894	.00855	.00819	.00785	.00753
8	.00951	.00909	.00871	.00835	.00801

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
9	.01019	.00975	.00934	.00896	.00860
10	.01099	.01052	.01008	.00967	.00930
11	.01191	.01142	.01095	.01052	.01012
12	.01295	.01243	.01194	.01148	.01106
13	.01406	.01351	.01299	.01251	.01206
14	.01518	.01459	.01405	.01354	.01306
15	.01625	.01563	.01506	.01452	.01402
16	.01724	.01659	.01599	.01542	.01489
17	.01815	.01747	.01683	.01624	.01568
18	.01901	.01829	.01761	.01699	.01640
19	.01984	.01908	.01837	.01771	.01709
20	.02070	.01990	.01915	.01846	.01780
21	.02160	.02075	.01996	.01923	.01854
22	.02253	.02164	.02080	.02003	.01930
23	.02352	.02258	.02170	.02088	.02010
24	.02462	.02362	.02269	.02182	.02100
25	.02586	.02481	.02382	.02289	.02203
26	.02729	.02617	.02512	.02414	.02322
27	.02891	.02772	.02662	.02558	.02460
28	.03074	.02949	.02832	.02722	.02618
29	.03276	.03143	.03019	.02902	.02792
30	.03497	.03357	.03225	.03102	.02985
31	.03735	.03587	.03448	.03317	.03193
32	.03993	.03837	.03690	.03551	.03420
33	.04273	.04108	.03952	.03806	.03667
34	.04572	.04399	.04234	.04079	.03933
35	.04896	.04713	.04539	.04376	.04221
36	.05243	.05049	.04867	.04694	.04530
37	.05613	.05410	.05217	.05035	.04862
38	.06007	.05793	.05591	.05399	.05217
39	.06425	.06200	.05987	.05785	.05593
40	.06869	.06633	.06409	.06197	.05995
41	.07339	.07092	.06857	.06634	.06421
42	.07840	.07581	.07335	.07101	.06878
43	.08370	.08099	.07841	.07595	.07361
44	.08930	.08646	.08377	.08119	.07874
45	.09517	.09222	.08940	.08670	.08413
46	.10136	.09828	.09533	.09252	.08983
47	.10786	.10464	.10157	.09864	.09582
48	.11470	.11136	.10816	.10510	.10216
49	.12189	.11842	.11509	.11190	.10884
50	.12946	.12585	.12239	.11907	.11588
51	.13737	.13363	.13003	.12659	.12327
52	.14565	.14177	.13805	.13447	.13103
53	.15429	.15028	.14642	.14271	.13914
54	.16327	.15912	.15513	.15129	.14759
55	.17259	.16831	.16419	.16022	.15639
56	.18225	.17784	.17358	.16948	.16553
57	.19227	.18773	.18335	.17912	.17503
58	.20265	.19798	.19347	.18911	.18490
59	.21343	.20863	.20400	.19951	.19518
60	.22460	.21968	.21492	.21032	.20586
61	.23620	.23117	.22629	.22156	.21698
62	.24824	.24309	.23810	.23325	.22856
63	.26073	.25546	.25036	.24540	.24060
64	.27364	.26827	.26306	.25800	.25308
65	.28696	.28150	.27619	.27103	.26601
66	.30070	.29515	.28974	.28449	.27937
67	.31483	.30919	.30371	.29836	.29316
68	.32936	.32365	.31808	.31266	.30737
69	.34432	.33854	.33290	.32741	.32204
70	.35972	.35389	.34820	.34264	.33721
71	.37565	.36977	.36403	.35842	.35294
72	.39210	.38619	.38042	.37477	.36924
73	.40900	.40308	.39728	.39161	.38605
74	.42618	.42025	.41444	.40876	.40318

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
75	.44345	.43753	.43173	.42604	.42046
76	.46073	.45483	.44904	.44336	.43779
77	.47799	.47212	.46635	.46069	.45513
78	.49524	.48941	.48368	.47805	.47252
79	.51256	.50678	.50110	.49551	.49001
80	.53001	.52429	.51867	.51313	.50769
81	.54745	.54181	.53626	.53079	.52541
82	.56476	.55921	.55374	.54835	.54303
83	.58193	.57648	.57110	.56579	.56056
84	.59907	.59373	.58845	.58325	.57811
85	.61624	.61102	.60586	.60077	.59574
86	.63300	.62791	.62289	.61791	.61300
87	.64883	.64387	.63896	.63411	.62932
88	.66363	.65880	.65402	.64929	.64461
89	.67775	.67304	.66838	.66377	.65921
90	.69160	.68703	.68250	.67802	.67357
91	.70509	.70066	.69626	.69191	.68760
92	.71775	.71345	.70919	.70496	.70078
93	.72929	.72512	.72099	.71689	.71282
94	.73964	.73559	.73157	.72758	.72362
95	.74867	.74472	.74081	.73692	.73306
96	.75625	.75239	.74856	.74476	.74099
97	.76303	.75925	.75550	.75177	.74807
98	.76892	.76521	.76152	.75786	.75422
99	.77443	.77078	.76715	.76355	.75998
100 ..	.77990	.77631	.77275	.76921	.76569
101 ..	.78463	.78109	.77757	.77407	.77060
102 ..	.78971	.78622	.78275	.77930	.77587
103 ..	.79629	.79287	.78947	.78608	.78272
104 ..	.80244	.79907	.79572	.79239	.78907
105 ..	.81198	.80871	.80546	.88222	.79900
106 ..	.82792	.82485	.82180	.81876	.81572
107 ..	.85057	.84783	.84509	.84237	.83964
108 ..	.88740	.88526	.88312	.88098	.87885
109 ..	.94900	.94800	.94700	.94600	.94500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
0	.02487	.02466	.02447	.02429	.02412
1	.00686	.00666	.00648	.00631	.00615
2	.00641	.00620	.00601	.00583	.00566
3	.00631	.00609	.00589	.00570	.00552
4	.00637	.00614	.00593	.00573	.00554
5	.00657	.00633	.00610	.00588	.00568
6	.00687	.00661	.00637	.00614	.00593
7	.00724	.00696	.00670	.00646	.00623
8	.00770	.00740	.00713	.00687	.00663
9	.00827	.00795	.00766	.00739	.00713
10	.00894	.00861	.00830	.00800	.00773
11	.00974	.00939	.00906	.00875	.00846
12	.01066	.01029	.00993	.00961	.00929
13	.01164	.01124	.01087	.01052	.01019
14	.01262	.01220	.01181	.01144	.01109
15	.01355	.01311	.01270	.01231	.01194
16	.01440	.01394	.01350	.01309	.01271
17	.01516	.01467	.01421	.01378	.01337

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
18	.01585	.01534	.01485	.01440	.01397
19	.01651	.01597	.01546	.01498	.01453
20	.01719	.01662	.01608	.01557	.01510
21	.01789	.01728	.01672	.01618	.01568
22	.01861	.01797	.01737	.01680	.01627
23	.01938	.01870	.01806	.01746	.01689
24	.02023	.01951	.01883	.01819	.01759
25	.02121	.02045	.01973	.01905	.01841
26	.02236	.02155	.02078	.02006	.01938
27	.02368	.02282	.02200	.02124	.02051
28	.02521	.02429	.02342	.02261	.02183
29	.02689	.02591	.02499	.02412	.02330
30	.02875	.02772	.02674	.02581	.02494
31	.03076	.02966	.02863	.02764	.02671
32	.03297	.03180	.03070	.02965	.02866
33	.03536	.03412	.03295	.03184	.03079
34	.03794	.03663	.03539	.03421	.03309
35	.04074	.03935	.03803	.03678	.03559
36	.04375	.04228	.04089	.03956	.03830
37	.04699	.04543	.04395	.04255	.04122
38	.05044	.04879	.04723	.04575	.04433
39	.05411	.05238	.5073	.04916	.04766
40	.05802	.05620	.05445	.05279	.05121
41	.06219	.06026	.05843	.05668	.05550
42	.06665	.06462	.06269	.06084	.05908
43	.07138	.06924	.06721	.06526	.06341
44	.07639	.07415	.07202	.06997	.06801
45	.08168	.07933	.07708	.07493	.07287
46	.08726	.08480	.08244	.08018	.07802
47	.09313	.09056	.08809	.08572	.08345
48	.09935	.09666	.09408	.09160	.08922
49	.10591	.10309	.10039	.09780	.09531
50	.11282	.10989	.10707	.10436	.10176
51	.12009	.11703	.11409	.11127	.10855
52	.12772	.12454	.12147	.11853	.11569
53	.13571	.13340	.12922	.12615	.12319
54	.14403	.14060	.13729	.13410	.13102
55	.15270	.14914	.14571	.14240	.13920
56	.16171	.15802	.15447	.15103	.14771
57	.17109	.16728	.16360	.16004	.15660
58	.18083	.17690	.17309	.16941	.16585
59	.19098	.18692	.18299	.17919	.17551
60	.20154	.19736	.19331	.18938	.18558
61	.21254	.20824	.20407	.20003	.19610
62	.22400	.21958	.21530	.21113	.20709
63	.23593	.23139	.22699	.22272	.21856
64	.24830	.24366	.23915	.23476	.23050
65	.26113	.25638	.25176	.24727	.24290
66	.27439	.26955	.26483	.26023	.25576
67	.28808	.28314	.27833	.27364	.26906
68	.30221	.29718	.29228	.28750	.28283
69	.31681	.31170	.30672	.30185	.29710
70	.33190	.32673	.32167	.31672	.31189
71	.34758	.34234	.33721	.33220	.32731
72	.36384	35855	.35337	.34831	.34335
73	.38061	.37529	.37007	.36496	.35996
74	.39772	.39237	.38713	.38199	.37695
75	.41499	.40962	.40436	.39920	.39413
76	.43232	.42695	.42168	.41650	.41142
77	.44967	.44431	.43904	.43386	.42878
78	.46708	.46173	.45647	.45130	.44622
79	.48460	.47928	.47405	.46890	.46383
80	.50232	.49705	.49185	.48673	.48169
81	.52010	.51487	.50973	.50465	.49965
82	.53779	.53263	.52754	.52252	.51757
83	.55540	.55031	.54529	.54033	.53544

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
84	.57304	.56804	.56309	.55822	.55340
85	.59077	.58586	.58102	.57623	.57150
86	.60815	.60335	.59860	.59392	.58928
87	.62458	.61989	.61525	.61066	.60613
88	.63998	.63540	.63086	.62638	.62194
89	.65469	.65022	.64579	.64141	.63707
90	.66918	.66482	.66050	.65623	.65199
91	.68332	.67909	.67489	.67073	.66661
92	.69662	.69251	.68843	.68439	.68038
93	.70879	.70479	.70082	.69689	.69299
94	.71970	.71581	.71195	.70812	.70432
95	.72924	.72544	.72167	.71793	.71422
96	.73724	.73353	.72984	.72618	.72254
97	.74440	.74076	.73714	.73354	.72998
98	.75061	.74703	.74347	.73994	.73643
99	.75642	.75290	.74939	.74591	.74245
100 ..	.76219	.75872	.75527	.75184	.74844
101 ..	.76715	.76372	.76031	.75692	.75356
102 ..	.77246	.76908	.76571	.76236	.75904
103 ..	.77937	.77605	.77274	.76945	.76618
104 ..	.78577	.78249	.77923	.77598	.77275
105 ..	.79579	.79259	.78941	.78625	.78310
106 ..	.81270	.80969	.80670	.80371	.80073
107 ..	.83693	.83422	.83152	.82883	.82614
108 ..	.87672	.87459	.87246	.87034	.86822
109 ..	.94400	.94300	.94200	.94100	.94000

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
0	.02396	.02380	.02366	.02352	.02338
1	.00600	.00585	.00572	.00559	.00547
2	.00550	.00535	.00521	.00508	.00495
3	.00536	.00520	.00505	.00491	.00478
4	.00536	.00519	.00504	.00489	.00475
5	.00549	.00532	.00515	.00499	.00484
6	.00572	.00554	.00536	.00519	.00503
7	.00602	.00582	.00563	.00545	.00528
8	.00640	.00618	.00598	.00579	.00561
9	.00688	.00665	.00644	.00623	.00604
10	.00747	.00723	.00699	.00678	.00657
11	.00818	.00792	.00767	.00744	.00722
12	.00900	.00873	.00846	.00822	.00798
13	.00988	.00959	.00931	.00905	.00880
14	.01077	.01046	.01017	.00989	.00963
15	.01160	.01127	.01097	.01067	.01040
16	.01234	.01200	.01167	.01137	.01108
17	.01299	.01263	.01229	.01197	.01166
18	.01357	.01319	.01283	.01249	.01217
19	.01410	.01370	.01332	.01297	.01263
20	.01465	.01422	.01382	.01345	.01309
21	.01520	.01475	.01433	.01393	.01355
22	.01576	.01529	.01484	.01442	.01402
23	.01636	.01586	.01538	.01493	.01450
24	.01703	.01649	.01599	.01551	.01505
25	.01781	.01724	.01670	.01619	.01571
26	.01874	.01813	.01756	.01701	.01650
27	.01983	.01918	.01857	.01799	.01744
28	.02111	.02042	.01976	.01915	.01856
29	.02253	.02179	.02110	.02044	.01981
30	.02411	.02333	.02259	.02188	.02121
31	.02583	.02500	.02421	.02345	.02274
32	.02772	.02683	.02599	.02519	.02443
33	.02979	.02885	.02795	.02709	.02628
34	.03203	.03102	.03006	.02915	.02829
35	.03447	.03340	.03238	.03141	.03048
36	.03710	.03597	.03488	.03385	.03286
37	.03995	.03874	.03758	.03649	.03544
38	.04299	.04170	.04048	.03931	.03820
39	.04623	.04487	.04358	.04234	.04115
40	.04970	.04826	.04689	.04558	.04432
41	.05341	.05189	.05043	.04904	.04771
42	.05739	.05578	.05424	.05277	.05136
43	.06163	.05993	.05830	.05674	.05525
44	.06614	.06435	.06263	.06099	.05941
45	.07090	.06901	.06720	.06547	.06380
46	.07595	.07396	.07206	.07023	.06847
47	.08128	.07919	.07718	.07525	.07340
48	.08693	.08474	.08263	.08061	.07866
49	.09291	.09061	.08840	.08627	.08423
50	.09925	.09684	.09452	.09229	.09014
51	.10593	.10341	.10098	.09864	.09638
52	.11296	.11032	.10778	.10534	.10297
53	.12034	.11759	.11494	.11238	.10991
54	.12805	.12519	.12243	.11976	.11718
55	.13611	.13313	.13025	.12747	.12478
56	.14451	.14141	.13841	.13551	.13271
57	.15327	.15005	.14694	.14393	.14101
58	.16240	.15906	.15583	.15270	.14967
59	.17194	.16848	.16513	.16189	.15874
60	.18189	.17831	.17485	.17148	.16822
61	.19230	.18860	.18502	.18154	.17816
62	.20317	.19936	.19566	.19207	.18857
63	.21453	.21060	.20679	.20308	.19947
64	.22635	.22231	.21839	.21457	.21085
65	.23864	.23450	.23046	.22653	.22271
66	.25140	.24715	.24301	.23898	.23505
67	.26461	.26026	.25602	.25188	.24785
68	.27828	.27384	.26950	.26527	.26114
69	.29246	.28793	.28350	.27918	.27496
70	.30718	.30256	.29805	.29364	.28933
71	.32251	.31783	.31324	.30876	.30437
72	.33850	.33375	.32910	.32455	.32009
73	.35506	.35026	.34555	.34094	.33642
74	.37201	.36716	.36241	.35776	.35319
75	.38916	.38429	.37950	.37481	.37020
76	.40644	.40154	.39673	.39200	.38737
77	.42378	.41887	.41404	.40930	.40464
78	.44123	.43631	.43148	.42673	.42205
79	.45885	.45394	.44911	.44436	.43969
80	.47673	.47184	.46703	.46229	.45763
81	.49473	.48987	.48509	.48037	.47573
82	.51269	.50787	.50313	.49845	.49383
83	.53062	.52586	.52116	.51653	.51195
84	.54864	.54395	.53931	.53473	.53021
85	.56683	.56221	.55765	.55314	.54869
86	.58470	.58017	.57570	.57127	.56689
87	.60164	.59720	.59281	.58847	.58417
88	.61754	.61320	.60889	.60464	.60042
89	.63277	.62851	.62430	.62013	.61600
90	.64780	.64364	.63953	.63545	.63141
91	.66252	.65848	.65446	.65049	.64655
92	.67640	.67246	.66856	.66468	.66084

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
93	.68912	.68528	.68148	.67770	.67396
94	.70055	.69680	.69309	.68941	.68576
95	.71054	.70689	.70326	.69966	.69609
96	.71893	.71535	.71180	.70827	.70476
97	.72643	.72292	.71943	.71596	.71252
98	.73294	.72948	.72604	.72263	.71924
99	.73902	.73561	.73222	.72886	.72551
100 ..	.74506	.74170	.73836	.73504	.73174
101 ..	.75021	.74689	.74359	.74030	.73704
102 ..	.75573	.75244	.74918	.74593	.74270
103 ..	.76293	.75970	.75649	.75329	.75011
104 ..	.76954	.76634	.76316	.76000	.75685
105 ..	.77996	.77684	.77373	.77064	.76756
106 ..	.79777	.79481	.79187	.78894	.78602
107 ..	.82346	.82078	.81812	.81546	.81281
108 ..	.86610	.86398	.86187	.85976	.85765
109 ..	.93900	.93800	.93700	.93600	.93500

TABLE E

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
0	.02325	.02313	.02301	.02290	.02279
1	.00536	.00525	.00514	.00505	.00495
2	.00484	.00472	.00462	.00451	.00442
3	.00465	.00453	.00442	.00431	.00421
4	.00461	.00449	.00437	.00426	.00415
5	.00470	.00457	.00444	.00432	.00421
6	.00488	.00474	.00460	.00447	.00435
7	.00512	.00496	.00482	.00468	.00455
8	.00543	.00527	.00512	.00497	.00483
9	.00585	.00568	.00551	.00536	.00521
10	.00637	.00619	.00601	.00584	.00568
11	.00701	.00681	.00662	.00644	.00627
12	.00776	.00755	.00735	.00716	.00697
13	.00857	.00734	.00813	.00793	.00773
14	.00938	.00914	.00892	.00870	.00850
15	.01014	.00989	.00965	.00942	.00921
16	.01080	.01054	.01029	.01005	.00983
17	.01137	.01109	.01083	.01058	.01035
18	.01186	.01157	.01130	.01103	.01078
19	.01230	.01300	.01171	.01143	.01117
20	.01275	.01243	.01212	.01183	.01155
21	.01319	.01285	.01253	.01222	.01193
22	.01364	.01328	.01293	.01261	.01230
23	.01410	.01372	.01336	.01301	.01268
24	.01463	.01422	.01383	.01347	.01312
25	.01525	.01482	.01441	.01401	.01364
26	.01601	.01555	.01511	.01469	.01430
27	.01692	.01643	.01596	.01551	.01509
28	.01800	.01748	.01697	.01650	.01604
29	.01922	.01865	.01812	.01760	.01712
30	.02058	.01998	.01940	.01886	.01833
31	.02206	.02142	.02080	.02022	.01966
32	.02370	.02301	.02236	.02173	.02113
33	.02550	.02477	.02407	.02340	.02276
34	.02746	.02667	.02592	.02521	.02452
35	.02960	.02876	.02796	.02719	.02646

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
36	.03193	.03103	.03017	.02936	.02858
37	.03444	.03348	.03257	.03170	.03087
38	.03714	.03612	.03515	.03422	.03333
39	.04002	.03894	.03791	.03692	.03597
40	.04312	.04197	.04087	.03891	.03880
41	.04643	.04521	.04404	.04292	.04185
42	.05001	.04871	.04747	.04628	.04514
43	.05382	.05245	.05113	.04987	.04865
44	.05789	.05644	.05505	.05371	.05242
45	.06220	.06067	.05919	.05777	.05641
46	.06678	.06516	.06360	.06210	.06065
47	.07162	.06991	.06826	.06668	.06515
48	.07678	.07498	.07324	.07157	.06996
49	.08225	.08035	.07852	.07676	.07506
50	.08807	.08607	.08415	.08229	.08050
51	.09421	.09211	.09009	.08814	.08625
52	.10070	.09850	.09637	.09432	.09234
53	.10753	.10523	.10300	.10085	.09877
54	.11468	.11227	.10994	.10769	.10551
55	.12218	.11966	.11722	.11487	.11258
56	.12999	.12737	.12483	.12236	.11998
57	.13818	.13545	.13279	.13022	.12773
58	.14673	.14388	.14112	.13844	.13584
59	.15568	.15272	.14985	.14706	.14435
60	.16505	.16198	.15899	.15609	.15327
61	.17488	.17169	.16859	.16558	.16265
62	.18518	.18187	.17866	.17554	.17251
63	.19596	.19255	.18923	.18600	.18285
64	.20723	.20371	.20028	.19694	.19368
65	.21898	.21535	.21181	.20836	.20500
66	.23121	.22748	.22383	.22028	.21681
67	.24392	.24008	.23633	.23267	.22910
68	.25711	.25317	.24932	.24556	.24189
69	.27083	.26680	.26285	.25900	.25523
70	.28512	.28100	.27697	.27302	.26916
71	.30007	.29587	.29176	.28773	.28378
72	.31572	.31145	.30726	.30315	.29913
73	.33199	.32765	.32340	.31923	.31514
74	.34871	.34431	.34000	.33577	.33162
75	.36568	.36124	.35688	.35260	.34840
76	.38281	.37833	.37393	.36961	.36537
77	.40006	.39555	.39113	.38677	.38249
78	.41745	.41293	.40848	.40410	.39980
79	.43508	.43055	.42609	.42170	.41737
80	.45303	.44850	.44404	.43964	.43531
81	.47115	.46663	.46218	.45779	.45347
82	.48928	.48479	.48036	.47599	.47168
83	.50744	.50298	.49858	.49424	.48995
84	.52575	.52134	.51698	.51268	.50843
85	.54429	.53994	.53564	.53139	.52720
86	.56257	.55829	.55406	.54988	.54574
87	.57993	.57572	.57156	.56745	.56338
88	.59625	.59212	.58804	.58399	.57999
89	.61191	.60786	.60384	.59987	.59594
90	.62741	.62344	.61952	.61562	.61177
91	.64264	.63877	.63493	.63113	.62736
92	.65703	.65326	.64951	.64580	.64212
93	.67024	.66656	.66291	.65928	.65568
94	.68213	.67854	.67497	.67142	.66791
95	.69255	.68903	.68554	.68207	.67863
96	.70128	.69783	.69440	.69100	.68762
97	.70910	.70570	.70233	.69899	.69566
98	.71587	.71252	.70920	.70590	.70263
99	.72219	.71889	.71562	.71236	.70913
100 ..	.72847	.72522	.72189	.71877	.71558
101 ..	.73380	.73058	.72738	.72420	.72104

TABLE E—Continued

TABLE E—SINGLE LIFE, UNISEX—TABLE SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Age	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
102 ..	.73949	.73630	.73313	.72998	.72685
103 ..	.74695	.74381	.74068	.73758	.73449
104 ..	.75372	.75060	.74751	.74442	.74136
105 ..	.76449	.76144	.75840	.75538	.75237
106 ..	.78311	.78021	.77732	.77444	.77157
107 ..	.81016	.80752	.80489	.80227	.79965
108 ..	.85554	.85344	.85134	.84924	.84715
109 ..	.93400	.93300	.93200	.93100	.93000

TABLE F(1)

TABLE F(1)—10 PERCENT—TABLE SHOWING FACTORS FOR COMPUTATIONS OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS AND PAYOUT SEQUENCES—APPLICABLE FOR TRANSFERS AFTER NOVEMBER 30, 1983, AND BEFORE MAY 1, 1989

(1) Number of months by which the valuation date precedes the first payout		(2) Factors for payout at the end of each			
At least	But less than	Annual period	Semiannual period	Quarterly period	Monthly period
	1		.976731	.965232	.957616
1	2	.992089	.969004	.957596	.950041
2	3	.984240	.961338	.950021	
3	4	.976454	.953733	.942505	
4	5	.968729	.946188		
5	6	.961066	.938703		
6	7	.953463	.931277		
7	8	.945920			
8	9	.938436			
9	10	.931012			
10	11	.923647			
11	12	.916340			
12		.909091			

(e) *Valuation of charitable remainder unitrusts having certain payout sequences for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999*—(1) *In general.* Except as otherwise provided in paragraph (e)(2) of this section, in the case of transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, the present value of a remainder interest is determined under paragraphs (e)(3) through (e)(6) of this section, provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount that the trust could distribute on such date under §1.664–3(a)(1)(v) if the taxable year of the trust were to end on such date. See, however, §1.7520–3(b) (relating to exceptions to the use of the prescribed tables under certain circumstances).

(2) *Transitional rules for valuation of charitable remainder unitrusts.* (i) If the valuation date of a transfer to a charitable remainder unitrust is after April 30, 1989, and before June 10, 1994, a transferor can rely upon Notice 89–24, 1989–1 C.B. 660, or Notice 89–60, 1989–1 C.B. 700, in valuing the transferred interest. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

(ii) For purposes of sections 2055, 2106, or 2624, if on May 1, 1989, the decedent was mentally incompetent so that the disposition of the property could not be changed, and the decedent died after April 30, 1989, without having regained competency to dispose of the decedent's property, or the decedent died within 90 days of the date that the decedent first regained competency after April 30, 1989, the present value of a remainder interest determined under this section is determined as if the valuation date with respect to the decedent's gross estate is either before May 1, 1989, or after April 30, 1989, at the option of the decedent's executor.

(3) *Adjusted payout rate.* For transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, the adjusted payout rate is determined

by using the appropriate Table F, contained in § 1.664–4(e)(6), for the section 7520 interest rate applicable to the transfer. If the interest rate is between 4.2 and 14 percent, see § 1.664–4(e)(6). If the interest rate is below 4.2 percent or greater than 14 percent, see § 1.664–4(b). See § 1.664–4(e) for rules applicable in determining the adjusted payout rate.

(4) *Period is a term of years.* If the period described in § 1.664–3(a)(5) is a term of years, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, is the factor under the appropriate adjusted payout rate in Table D in § 1.664–4(e)(6) corresponding to the number of years in the term. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph. Generally, for purposes of this section, the valuation date is, in the case of an inter vivos transfer, the date on which the property is transferred to the trust by the donor, and, in the case of a testamentary transfer under sections 2055, 2106, or 2624, the valuation date is the date of death. See § 1.664–4(e)(4) for additional rules regarding the valuation date. See § 1.664–4(e)(4) for an example that illustrates the application of this paragraph (e)(4).

(5) *Period is the life of one individual.* If the period described in § 1.664–3(a)(5) is the life of one individual, the factor that is used in determining the present value of the remainder interest for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, is the factor in Table U(1) in paragraph (e)(6) of this section under the appropriate adjusted payout. For purposes of the computations described in this paragraph (e)(5), the age of an individual is the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount that is between adjusted payout rates for which factors are provided in the appropriate table, a linear interpolation must be made. The rules provided in § 1.664–4(e)(5) apply for determining the present value of the remainder interest. See § 1.664–4(e)(5) for an example illustrating the application of this paragraph (e)(5)(using current actuarial tables).

(6) *Actuarial tables for transfers for which the valuation date is after April 30, 1989, and before May 1, 1999.* For transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, the present value of a charitable remainder unitrust interest that is dependent on a term of years or the termination of a life interest is determined by using the section 7520 rate and Table D, Tables F(4.2) through F(14.0) in § 1.664–4(e)(6) and Table U(1) of this paragraph (e)(6), as applicable. See, however, § 1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Many actuarial factors not contained in the following tables are contained in Internal Revenue Service Publication 1458, ''Actuarial Values, Beta Volume,'' (8–89). Publication 1458 is no longer available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. However, pertinent factors in this publication may be obtained by a written request to: CC:DOM:CORP:R (IRS Publication 1458), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

TABLE U(1)—UNITRUST SINGLE LIFE REMAINDER FACTORS—BASED ON LIFE TABLE 80CNSMT

[Applicable for Transfers After April 30, 1989, and Before May 1, 1999]

Age	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
0	.06797	.06181	.05645	.05177	.04768	.04410	.04096	.03820	.03578	.03364
1	.05881	.05243	.04686	.04199	.03773	.03400	.03072	.02784	.02531	.02308
2	.06049	.05394	.04821	.04319	.03880	.03494	.03155	.02856	.02593	.02361
3	.06252	.05579	.04990	.04473	.04020	.03621	.03270	.02961	.02688	.02446
4	.06479	.05788	.05182	.04650	.04183	.03771	.03408	.03087	.02804	.02553

TABLE U(1)—UNITRUST SINGLE LIFE REMAINDER FACTORS—BASED ON LIFE TABLE 80CNSMT—Continued

[Applicable for Transfers After April 30, 1989, and Before May 1, 1999]

Age	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
5	.06724	.06016	.05393	.04845	.04363	.03937	.03562	.03230	.02936	.02675
6	.06984	.06257	.05618	.05054	.04557	.04117	.03729	.03385	.03080	.02809
7	.07259	.06513	.05856	.05276	.04764	.04310	.03909	.03552	.03236	.02954
8	.07548	.06784	.06109	.05513	.04985	.04517	.04102	.03733	.03405	.03113
9	.07854	.07071	.06378	.05765	.05221	.04738	.04310	.03928	.03588	.03285
10	.08176	.07374	.06663	.06033	.05473	.04976	.04533	.04138	.03786	.03471
11	.08517	.07695	.06966	.06319	.05743	.05230	.04772	.04364	.04000	.03673
12	.08872	.08031	.07284	.06619	.06026	.05498	.05026	.04604	.04227	.03889
13	.09238	.08378	.07612	.06929	.06320	.05776	.05289	.04853	.04463	.04113
14	.09608	.08728	.07943	.07243	.06616	.06056	.05554	.05104	.04701	.04338
15	.09981	.09081	.08276	.07557	.06914	.06337	.05820	.05356	.04938	.04563
16	.10356	.09435	.08612	.07874	.07213	.06619	.06086	.05607	.05176	.04787
17	.10733	.09792	.08949	.08192	.07513	.06902	.06353	.05858	.05413	.05010
18	.11117	.10155	.09291	.08515	.07817	.07189	.06623	.06113	.05652	.05236
19	.11509	.10526	.09642	.08847	.08130	.07484	.06901	.06375	.05899	.05469
20	.11913	.10908	.10003	.09188	.08452	.07788	.07188	.06645	.06154	.05708
21	.12326	.11300	.10375	.09539	.08784	.08101	.07483	.06923	.06416	.05955
22	.12753	.11705	.10758	.09902	.09127	.08426	.07789	.07212	.06688	.06212
23	.13195	.12125	.11156	.10279	.09484	.08763	.08109	.07514	.06973	.06481
24	.13655	.12563	.11573	.10675	.09860	.09119	.08446	.07833	.07274	.06766
25	.14136	.13022	.12010	.11091	.10255	.09495	.08802	.08171	.07595	.07069
26	.14640	.13504	.12471	.11530	.10674	.09893	.09181	.08531	.07937	.07394
27	.15169	.14011	.12956	.11994	.11117	.10316	.09584	.08915	.08302	.07742
28	.15721	.14542	.13465	.12482	.11583	.10762	.10010	.09322	.08691	.08112
29	.16299	.15097	.13999	.12994	.12075	.11233	.10461	.09753	.09104	.08507
30	.16901	.15678	.14559	.13533	.12592	.11729	.10937	.10210	.09541	.08926
31	.17531	.16287	.15146	.14099	.13137	.12254	.11441	.10694	.10006	.09372
32	.18186	.16921	.15759	.14691	.13709	.12804	.11972	.11205	.10497	.09844
33	.18869	.17584	.16401	.15312	.14309	.13384	.12531	.11744	.11017	.10345
34	.19578	.18273	.17070	.15961	.14937	.13992	.13119	.12312	.11565	.10874
35	.20315	.18990	.17767	.16637	.15593	.14628	.13735	.12908	.12142	.11431
36	.21076	.19732	.18490	.17340	.16276	.15291	.14377	.13531	.12745	.12016
37	.21863	.20501	.19239	.18071	.16987	.15982	.15049	.14182	.13377	.12628
38	.22676	.21296	.20016	.18828	.17725	.16701	.15748	.14862	.14037	.13269
39	.23515	.22118	.20820	.19614	.18492	.17448	.16476	.15571	.14727	.13940
40	.24379	.22967	.21652	.20428	.19288	.18225	.17234	.16310	.15447	.14641
41	.25270	.23842	.22511	.21270	.20112	.19031	.18021	.17078	.16197	.15372
42	.26184	.24742	.23395	.22137	.20962	.19864	.18836	.17875	.16975	.16132
43	.27123	.25666	.24305	.23031	.21840	.20724	.19679	.18700	.17782	.16921
44	.28085	.26616	.25241	.23952	.22745	.21613	.20551	.19554	.18618	.17739
45	.29072	.27591	.26203	.24901	.23678	.22530	.21452	.20438	.19485	.18589
46	.30082	.28591	.27191	.25875	.24639	.23476	.22381	.21352	.20382	.19468
47	.31116	.29616	.28204	.26877	.25626	.24449	.23340	.22295	.21309	.20379
48	.32171	.30663	.29241	.27902	.26640	.25449	.24326	.23265	.22264	.21318
49	.33245	.31730	.30300	.28950	.27676	.26473	.25336	.24262	.23246	.22285
50	.34338	.32816	.31379	.30020	.28735	.27521	.26371	.25283	.24253	.23277
51	.35449	.33923	.32479	.31112	.29818	.28593	.27431	.26331	.25287	.24297
52	.36582	.35053	.33603	.32230	.30927	.29692	.28520	.27408	.26352	.25349
53	.37736	.36205	.34751	.33372	.32063	.30819	.29637	.28514	.27446	.26431
54	.38909	.37376	.35921	.34537	.33221	.31970	.30780	.29647	.28569	.27542
55	.40099	.38568	.37111	.35724	.34404	.33146	.31949	.30807	.29719	.28681
56	.41308	.39779	.38322	.36934	.35610	.34348	.33143	.31994	.30898	.29851
57	.42536	.41011	.39555	.38167	.36841	.35575	.34366	.33210	.32106	.31051
58	.43781	.42262	.40810	.39422	.38096	.36828	.35615	.34454	.33344	.32281
59	.45043	.43530	.42083	.40698	.39373	.38104	.36888	.35724	.34609	.33540
60	.46318	.44813	.43372	.41992	.40668	.39400	.38183	.37017	.35898	.34824
61	.47602	.46107	.44674	.43299	.41979	.40713	.39497	.38329	.37207	.36129
62	.48893	.47410	.45986	.44617	.43303	.42039	.40825	.39657	.38534	.37454
63	.50190	.48720	.47306	.45946	.44638	.43379	.42168	.41001	.39878	.38796
64	.51494	.50038	.48636	.47286	.45986	.44733	.43526	.42362	.41240	.40158
65	.52808	.51368	.49980	.48641	.47350	.46104	.44903	.43743	.42624	.41544
66	.54134	.52711	.51338	.50013	.48733	.47496	.46302	.45148	.44033	.42956
67	.55471	.54068	.52712	.51401	.50134	.48908	.47723	.46577	.45467	.44394
68	.56820	.55437	.54100	.52805	.51552	.50339	.49165	.48027	.46925	.45858
69	.58172	.56812	.55495	.54219	.52982	.51783	.50620	.49494	.48401	.47341
70	.59526	.58190	.56894	.55637	.54417	.53234	.52086	.50971	.49889	.48838
71	.60874	.59564	.58291	.57055	.55854	.54687	.53554	.52453	.51382	.50342
72	.62218	.60934	.59685	.58471	.57291	.56143	.55026	.53939	.52882	.51854

TABLE U(1)—UNITRUST SINGLE LIFE REMAINDER FACTORS—BASED ON LIFE TABLE 80CNSMT—Continued

[Applicable for Transfers After April 30, 1989, and Before May 1, 1999]

Age	Adjusted payout rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
73	.63557	.62301	.61078	.59887	.58728	.57600	.56501	.55431	.54389	.53373
74	.64896	.63669	.62472	.61307	.60171	.59064	.57985	.56932	.55906	.54906
75	.66237	.65040	.63872	.62733	.61622	.60538	.59480	.58447	.57439	.56455
76	.67581	.66416	.65279	.64168	.63083	.62023	.60988	.59977	.58989	.58023
77	.68925	.67793	.66688	.65606	.64550	.63516	.62506	.61517	.60551	.59605
78	.70263	.69166	.68093	.67044	.66016	.65010	.64026	.63062	.62119	.61195
79	.71585	.70525	.69486	.68468	.67471	.66495	.65538	.64600	.63681	.62780
80	.72885	.71860	.70856	.69872	.68906	.67959	.67031	.66120	.65227	.64350
81	.74150	.73162	.72193	.71242	.70308	.69392	.68492	.67609	.66742	.65890
82	.75376	.74425	.73490	.72572	.71671	.70785	.69915	.69059	.68219	.67393
83	.76559	.75643	.74744	.73859	.72989	.72134	.71293	.70466	.69652	.68852
84	.77700	.76821	.75955	.75104	.74266	.73441	.72629	.71831	.71044	.70270
85	.78805	.77961	.77130	.76311	.75505	.74711	.73929	.73158	.72399	.71652
86	.79866	.79056	.78258	.77472	.76697	.75933	.75180	.74438	.73707	.72985
87	.80870	.80094	.79329	.78574	.77829	.77095	.76370	.75656	.74951	.74255
88	.81825	.81081	.80348	.79623	.78908	.78202	.77506	.76818	.76139	.75469
89	.82746	.82035	.81332	.80638	.79952	.79275	.78606	.77945	.77292	.76647
90	.83643	.82963	.82291	.81627	.80971	.80322	.79681	.79047	.78420	.77801
91	.84503	.83854	.83212	.82578	.81950	.81330	.80716	.80109	.79509	.78915
92	.85308	.84689	.84076	.83470	.82870	.82276	.81689	.81107	.80532	.79963
93	.86052	.85460	.84875	.84295	.83721	.83152	.82590	.82033	.81481	.80935
94	.86729	.86163	.85602	.85046	.84496	.83951	.83412	.82877	.82348	.81823
95	.87338	.86795	.86257	.85723	.85195	.84672	.84153	.83639	.83129	.82624
96	.87877	.87354	.86836	.86323	.85814	.85309	.84809	.84313	.83822	.83334
97	.88365	.87861	.87362	.86867	.86375	.85888	.85405	.84926	.84450	.83979
98	.88805	.88318	.87835	.87356	.86880	.86409	.85941	.85477	.85016	.84559
99	.89210	.88739	.88271	.87807	.87347	.86890	.86436	.85986	.85539	.85095
100	.89588	.89131	.88678	.88227	.87780	.87337	.86896	.86459	.86024	.85593
101	.89949	.89506	.89066	.88629	.88195	.87764	.87336	.86911	.86488	.86069
102	.90325	.89897	.89471	.89047	.88627	.88209	.87794	.87381	.86971	.86564
103	.90724	.90311	.89900	.89491	.89085	.88681	.88279	.87880	.87484	.87089
104	.91167	.90770	.90376	.89983	.89593	.89205	.88819	.88435	.88053	.87673
105	.91708	.91333	.90959	.90587	.90217	.89848	.89481	.89116	.88752	.88391
106	.92470	.92126	.91782	.91440	.91100	.90760	.90422	.90085	.89749	.89414
107	.93545	.93246	.92948	.92650	.92353	.92057	.91762	.91467	.91173	.90880
108	.95239	.95016	.94792	.94569	.94346	.94123	.93900	.93678	.93456	.93234
109	.97900	.97800	.97700	.97600	.97500	.97400	.97300	.97200	.97100	.97000

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03176	.03009	.02861	.02730	.02613	.02509	.02416	.02333	.02258	.02191
1	.02110	.01936	.01781	.01644	.01522	.01413	.01316	.01229	.01150	.01080
2	.02156	.01974	.01812	.01669	.01541	.01427	.01325	.01234	.01152	.01078
3	.02233	.02043	.01875	.01725	.01591	.01471	.01364	.01268	.01182	.01105
4	.02330	.02132	.01956	.01800	.01660	.01535	.01422	.01322	.01231	.01149
5	.02443	.02237	.02054	.01890	.01743	.01612	.01494	.01389	.01293	.01208
6	.02568	.02353	.02162	.01990	.01837	.01700	.01576	.01465	.01365	.01275
7	.02704	.02480	.02280	.02102	.01941	.01798	.01668	.01552	.01446	.01351
8	.02852	.02619	.02411	.02224	.02057	.01906	.01770	.01648	.01537	.01437
9	.03014	.02772	.02554	.02360	.02184	.02027	.01885	.01756	.01640	.01535
10	.03190	.02938	.02711	.02508	.02325	.02160	.02012	.01877	.01755	.01645
11	.03381	.03119	.02883	.02672	.02481	.02308	.02153	.02012	.01884	.01768
12	.03585	.03313	.03068	.02847	.02648	.02468	.02305	.02157	.02023	.01902
13	.03798	.03515	.03260	.03030	.02822	.02635	.02464	.02310	.02170	.02042
14	.04012	.03718	.03453	.03213	.02997	.02801	.02623	.02462	.02315	.02181
15	.04225	.03919	.03644	.03395	.03169	.02965	.02779	.02611	.02457	.02317
16	.04436	.04120	.03833	.03574	.03339	.03126	.02932	.02756	.02595	.02449
17	.04647	.04319	.04021	.03752	.03507	.03285	.03082	.02898	.02730	.02577
18	.04860	.04519	.04210	.03930	.03675	.03443	.03232	.03040	.02864	.02703
19	.05079	.04725	.04404	.04113	.03847	.03606	.03386	.03185	.03001	.02833
20	.05304	.04938	.04604	.04301	.04025	.03773	.03543	.03333	.03141	.02965
21	.05537	.05157	.04811	.04495	.04208	.03945	.03705	.03486	.03285	.03101

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
22	.05779	.05385	.05025	.04698	.04398	.04125	.03874	.03645	.03435	.03242
23	.06032	.05623	.05250	.04910	.04598	.04313	.04052	.03812	.03592	.03390
24	.06302	.05878	.05491	.05136	.04812	.04515	.04242	.03992	.03762	.03550
25	.06589	.06150	.05748	.05380	.05042	.04733	.04448	.04187	.03946	.03725
26	.06897	.06442	.06025	.05643	.05292	.04969	.04673	.04400	.04148	.03916
27	.07228	.06757	.06325	.05928	.05563	.05227	.04917	.04632	.04369	.04126
28	.07582	.07094	.06646	.06234	.05854	.05504	.05182	.04884	.04609	.04355
29	.07958	.07454	.06990	.06562	.06167	.05804	.05468	.05157	.04870	.04604
30	.08360	.07838	.07357	.06913	.06504	.06125	.05775	.05452	.05152	.04874
31	.08788	.08249	.07751	.07291	.06866	.06472	.06108	.05771	.05457	.05167
32	.09242	.08685	.08170	.07694	.07252	.06844	.06465	.06113	.05786	.05483
33	.09724	.09149	.08617	.08124	.07666	.07242	.06848	.06482	.06141	.05824
34	.10234	.09641	.09091	.08581	.08107	.07667	.07257	.06876	.06521	.06191
35	.10773	.10161	.09594	.09066	.08575	.08119	.07694	.07298	.06928	.06583
36	.11338	.10708	.10122	.09577	.09070	.08597	.08156	.07744	.07360	.07001
37	.11932	.11283	.10680	.10117	.09592	.09102	.08645	.08217	.07818	.07444
38	.12554	.11887	.11265	.10685	.10142	.09636	.09162	.08719	.08304	.07915
39	.13206	.12521	.11880	.11282	.10722	.10198	.09708	.09249	.08818	.08414
40	.13888	.13184	.12526	.11909	.11332	.10791	.10284	.09808	.09361	.08942
41	.14601	.13878	.13201	.12567	.11972	.11414	.10890	.10398	.09935	.09499
42	.15342	.14601	.13906	.13254	.12641	.12066	.11525	.11016	.10537	.10086
43	.16112	.15353	.14640	.13970	.13340	.12747	.12189	.11663	.11168	.10701
44	.16913	.16136	.15406	.14718	.14070	.13460	.12885	.12342	.11830	.11347
45	.17745	.16951	.16202	.15497	.14832	.14204	.13612	.13053	.12525	.12025
46	.18608	.17796	.17030	.16308	.15625	.14981	.14372	.13796	.13251	.12735
47	.19501	.18673	.17890	.17150	.16451	.15790	.15164	.14571	.14010	.13478
48	.20425	.19579	.18780	.18024	.17308	.16630	.15987	.15378	.14800	.14252
49	.21375	.20514	.19698	.18926	.18193	.17499	.16840	.16214	.15620	.15056
50	.22352	.21476	.20644	.19856	.19107	.18396	.17721	.17080	.16470	.15890
51	.23358	.22467	.21620	.20816	.20051	.19325	.18634	.17976	.17350	.16755
52	.24396	.23490	.22628	.21809	.21030	.20288	.19581	.18908	.18267	.17655
53	.25465	.24545	.23670	.22836	.22042	.21285	.20563	.19875	.19218	.18592
54	.26563	.25631	.24742	.23895	.23086	.22315	.21579	.20876	.20204	.19562
55	.27692	.26747	.25846	.24986	.24164	.23379	.22628	.21911	.21225	.20568
56	.28850	.27895	.26982	.26109	.25275	.24476	.23712	.22981	.22281	.21611
57	.30041	.29076	.28152	.27267	.26421	.25610	.24833	.24089	.23376	.22691
58	.31263	.30288	.29355	.28460	.27602	.26780	.25991	.25234	.24508	.23811
59	.32515	.31532	.30590	.29685	.28817	.27984	.27184	.26416	.25677	.24968
60	.33793	.32803	.31853	.30940	.30062	.29219	.28409	.27630	.26880	.26159
61	.35093	.34098	.33141	.32220	.31335	.30483	.29663	.28873	.28113	.27381
62	.36414	.35414	.34451	.33524	.32631	.31771	.30942	.30144	.29374	.28631
63	.37754	.36750	.35783	.34850	.33951	.33084	.32247	.31440	.30661	.29910
64	.39115	.38108	.37137	.36200	.35296	.34422	.33579	.32765	.31978	.31217
65	.40500	.39493	.38519	.37579	.36670	.35792	.34943	.34122	.33328	.32560
66	.41914	.40906	.39932	.38990	.38079	.37197	.36343	.35517	.34717	.33943
67	.43355	.42350	.41376	.40434	.39521	.38636	.37780	.36950	.36145	.35365
68	.44824	.43822	.42851	.41909	.40996	.40111	.39252	.38419	.37611	.36827
69	.46313	.45316	.44348	.43409	.42498	.41613	.40754	.39919	.39109	.38322
70	.47818	.46827	.45864	.44929	.44020	.43137	.42279	.41445	.40634	.39845
71	.49331	.48348	.47391	.46461	.45557	.44677	.43821	.42988	.42177	.41388
72	.50853	.49879	.48930	.48007	.47108	.46233	.45380	.44550	.43741	.42952
73	.52384	.51421	.50482	.49566	.48674	.47805	.46957	.46130	.45324	.44538
74	.53930	.52979	.52050	.51145	.50261	.49399	.48557	.47736	.46934	.46152
75	.55495	.54557	.53641	.52747	.51873	.51020	.50187	.49372	.48577	.47799
76	.57079	.56157	.55256	.54374	.53513	.52670	.51847	.51041	.50253	.49483
77	.58680	.57775	.56890	.56024	.55176	.54346	.53534	.52739	.51960	.51198
78	.60291	.59405	.58537	.57687	.56855	.56040	.55241	.54458	.53691	.52940
79	.61898	.61032	.60184	.59353	.58537	.57738	.56954	.56185	.55431	.54691
80	.63491	.62647	.61819	.61007	.60210	.59428	.58660	.57907	.57167	.56441
81	.65054	.64234	.63427	.62636	.61858	.61094	.60344	.59606	.58882	.58170
82	.66582	.65784	.65000	.64229	.63472	.62727	.61994	.61274	.60566	.59870
83	.68065	.67291	.66530	.65781	.65044	.64319	.63605	.62903	.62212	.61532
84	.69508	.68758	.68020	.67293	.66577	.65872	.65178	.64495	.63821	.63158
85	.70915	.70190	.69475	.68770	.68076	.67392	.66718	.66054	.65399	.64754
86	.72274	.71573	.70882	.70200	.69528	.68865	.68212	.67567	.66931	.66304
87	.73569	.72892	.72224	.71565	.70915	.70273	.69639	.69014	.68397	.67788
88	.74807	.74154	.73509	.72872	.72243	.71622	.71009	.70403	.69805	.69214
89	.76010	.75381	.74759	.74144	.73537	.72937	.72344	.71758	.71179	.70607

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable After April 30, 1989]

Age	Adjusted payout rate									
	6.2%	6.4%	6.6%	6.8%	7.0%	7.2%	7.4%	7.6%	7.8%	8.0%
90	.77189	.76584	.75985	.75394	.74809	.74230	.73659	.73093	.72534	.71981
91	.78327	.77746	.77171	.76603	.76040	.75484	.74933	.74388	.73850	.73316
92	.79399	.78841	.78289	.77743	.77202	.76667	.76137	.75613	.75093	.74579
93	.80394	.79858	.79328	.78803	.78283	.77768	.77258	.76753	.76252	.75757
94	.81303	.80788	.80278	.79773	.79272	.78776	.78284	.77797	.77315	.76837
95	.82124	.81628	.81136	.80649	.80166	.79687	.79213	.78742	.78276	.77814
96	.82851	.82372	.81897	.81426	.80959	.80496	.80036	.79581	.79129	.78682
97	.83512	.83048	.82588	.82132	.81679	.81230	.80785	.80343	.79905	.79471
98	.84106	.83656	.83210	.82767	.82328	.81892	.81459	.81030	.80604	.80181
99	.84655	.84218	.83785	.83354	.82927	.82503	.82082	.81664	.81249	.80837
100	.85165	.84740	.84318	.83899	.83483	.83070	.82660	.82252	.81848	.81446
101	.85652	.85238	.84827	.84419	.84013	.83611	.83210	.82813	.82418	.82026
102	.86159	.85757	.85358	.84960	.84566	.84174	.83784	.83397	.83012	.82630
103	.86697	.86307	.85920	.85535	.85152	.84771	.84392	.84016	.83642	.83270
104	.87295	.86919	.86544	.86172	.85802	.85434	.85068	.84704	.84341	.83981
105	.88030	.87672	.87315	.86959	.86605	.86253	.85903	.85554	.85207	.84861
106	.89081	.88749	.88418	.88088	.87760	.87433	.87106	.86782	.86458	.86135
107	.90588	.90296	.90005	.89715	.89425	.89137	.88849	.88561	.88275	.87989
108	.93013	.92791	.92570	.92350	.92129	.91909	.91689	.91469	.91250	.91031
109	.96900	.96800	.96700	.96600	.96500	.96400	.96300	.96200	.96100	.96000

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02130	.02075	.02025	.01980	.01939	.01901	.01867	.01835	.01806	.01779
1	.01017	.00960	.00908	.00861	.00819	.00780	.00745	.00712	.00683	.00655
2	.01011	.00951	.00897	.00848	.00803	.00762	.00725	.00690	.00659	.00630
3	.01035	.00971	.00914	.00862	.00815	.00771	.00732	.00696	.00663	.00632
4	.01076	.01009	.00948	.00894	.00843	.00798	.00756	.00718	.00683	.00650
5	.01130	.01059	.00996	.00938	.00885	.00836	.00792	.00752	.00714	.00680
6	.01193	.01119	.01051	.00990	.00934	.00883	.00836	.00793	.00754	.00717
7	.01265	.01187	.01116	.01051	.00992	.00938	.00888	.00842	.00800	.00762
8	.01347	.01264	.01189	.01121	.01058	.01001	.00948	.00900	.00856	.00815
9	.01440	.01353	.01274	.01201	.01135	.01075	.01019	.00968	.00921	.00877
10	.01544	.01453	.01369	.01293	.01223	.01159	.01101	.01046	.00997	.00950
11	.01662	.01566	.01478	.01398	.01324	.01257	.01195	.01137	.01085	.01036
12	.01791	.01690	.01597	.01513	.01435	.01364	.01298	.01238	.01182	.01131
13	.01926	.01820	.01722	.01634	.01552	.01477	.01408	.01344	.01285	.01231
14	.02059	.01948	.01846	.01752	.01667	.01588	.01515	.01448	.01386	.01328
15	.02189	.02072	.01965	.01867	.01777	.01694	.01617	.01547	.01481	.01421
16	.02315	.02192	.02080	.01977	.01882	.01795	.01714	.01640	.01572	.01508
17	.02436	.02308	.02190	.02082	.01982	.01891	.01806	.01728	.01656	.01589
18	.02556	.02422	.02298	.02184	.02080	.01983	.01894	.01812	.01736	.01665
19	.02679	.02537	.02408	.02288	.02178	.02077	.01983	.01897	.01817	.01742
20	.02804	.02656	.02519	.02394	.02278	.02172	.02073	.01982	.01898	.01819
21	.02932	.02776	.02633	.02501	.02380	.02268	.02164	.02068	.01979	.01896
22	.03065	.02902	.02751	.02613	.02485	.02367	.02258	.02157	.02063	.01976
23	.03204	.03033	.02876	.02730	.02595	.02471	.02356	.02249	.02150	.02058
24	.03356	.03176	.03010	.02857	.02716	.02585	.02463	.02351	.02246	.02149
25	.03520	.03332	.03158	.02997	.02848	.02710	.02582	.02463	.02352	.02249
26	.03702	.03504	.03321	.03152	.02995	.02850	.02714	.02589	.02472	.02363
27	.03902	.03695	.03502	.03324	.03159	.03006	.02863	.02730	.02607	.02492
28	.04120	.03902	.03700	.03513	.03339	.03178	.03027	.02887	.02757	.02635
29	.04358	.04129	.03917	.03720	.03537	.03367	.03208	.03061	.02923	.02794
30	.04616	.04376	.04154	.03947	.03754	.03575	.03408	.03251	.03106	.02969
31	.04897	.04646	.04413	.04195	.03993	.03804	.03627	.03463	.03309	.03165
32	.05200	.04938	.04693	.04465	.04252	.04053	.03867	.03693	.03531	.03378
33	.05529	.05254	.04998	.04758	.04534	.04325	.04130	.03946	.03775	.03614
34	.05883	.05595	.05326	.05075	.04840	.04620	.04414	.04221	.04040	.03870
35	.06262	.05961	.05680	.05417	.05170	.04939	.04723	.04520	.04329	.04149
36	.06665	.06351	.06057	.05781	.05523	.05280	.05053	.04839	.04638	.04449
37	.07094	.06766	.06459	.06171	.05900	.05646	.05407	.05182	.04971	.04771
38	.07550	.07208	.06888	.06586	.06303	.06037	.05786	.05550	.05327	.05118

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
39	.08034	.07678	.07344	.07029	.06733	.06454	.06191	.05943	.05709	.05489
40	.08547	.08177	.07828	.07499	.07190	.06898	.06623	.06363	.06118	.05886
41	.09090	.08704	.08341	.07998	.07675	.07371	.07083	.06811	.06553	.06310
42	.09661	.09260	.08882	.08525	.08188	.07870	.07569	.07284	.07015	.06760
43	.10260	.09844	.09451	.09080	.08729	.08397	.08083	.07785	.07503	.07236
44	.10891	.10459	.10051	.09666	.09300	.08954	.08626	.08316	.08021	.07741
45	.11553	.11106	.10683	.10282	.09902	.09542	.09201	.08876	.08568	.08276
46	.12247	.11784	.11346	.10930	.10536	.10161	.09806	.09468	.09146	.08841
47	.12974	.12496	.12042	.11611	.11202	.10813	.10443	.10091	.09756	.09438
48	.13732	.13238	.12769	.12323	.11899	.11495	.11111	.10745	.10397	.10065
49	.14520	.14011	.13526	.13064	.12625	.12207	.11809	.11429	.11066	.10721
50	.15338	.14812	.14312	.13836	.13381	.12948	.12535	.12141	.11765	.11405
51	.16187	.15646	.15130	.14639	.14169	.13721	.13294	.12885	.12495	.12121
52	.17072	.16516	.15985	.15478	.14993	.14531	.14088	.13665	.13261	.12873
53	.17993	.17422	.16876	.16353	.15854	.15377	.14920	.14482	.14064	.13662
54	.18949	.18362	.17801	.17264	.16750	.16258	.15787	.15335	.14902	.14486
55	.19940	.19339	.18763	.18212	.17683	.17176	.16690	.16224	.15777	.15348
56	.20968	.20353	.19762	.19196	.18654	.18132	.17632	.17152	.16691	.16247
57	.22035	.21406	.20802	.20222	.19665	.19129	.18615	.18121	.17646	.17189
58	.23142	.22499	.21881	.21287	.20717	.20168	.19640	.19132	.18643	.18172
59	.24286	.23630	.23000	.22393	.21809	.21247	.20705	.20184	.19682	.19198
60	.25465	.24797	.24154	.23534	.22938	.22363	.21808	.21274	.20759	.20262
61	.26676	.25996	.25341	.24710	.24101	.23513	.22946	.22399	.21871	.21361
62	.27916	.27225	.26559	.25916	.25295	.24695	.24117	.23557	.23017	.22495
63	.29184	.28483	.27806	.27152	.26520	.25909	.25319	.24748	.24196	.23661
64	.30483	.29772	.29085	.28421	.27779	.27157	.26555	.25973	.25409	.24863
65	.31817	.31098	.30402	.29729	.29076	.28444	.27832	.27240	.26665	.26108
66	.33192	.32466	.31762	.31079	.30418	.29777	.29155	.28552	.27968	.27400
67	.34609	.33876	.33164	.32474	.31805	.31156	.30525	.29913	.29319	.28742
68	.36066	.35328	.34610	.33914	.33238	.32581	.31943	.31323	.30720	.30134
69	.37558	.36815	.36093	.35391	.34709	.34045	.33400	.32773	.32163	.31569
70	.39078	.38332	.37606	.36900	.36213	.35545	.34894	.34260	.33643	.33042
71	.40620	.39872	.39144	.38435	.37744	.37071	.36415	.35776	.35153	.34547
72	.42184	.41435	.40706	.39994	.39301	.38625	.37965	.37322	.36694	.36082
73	.43771	.43023	.42293	.41581	.40886	.40207	.39545	.38899	.38267	.37651
74	.45387	.44641	.43912	.43201	.42505	.41826	.41163	.40514	.39881	.39261
75	.47039	.46296	.45570	.44861	.44167	.43488	.42824	.42175	.41541	.40920
76	.48729	.47991	.47269	.46563	.45872	.45196	.44534	.43886	.43251	.42630
77	.50452	.49722	.49006	.48305	.47619	.46946	.46287	.45642	.45009	.44389
78	.52203	.51481	.50773	.50079	.49399	.48732	.48078	.47437	.46808	.46191
79	.53966	.53254	.52556	.51870	.51198	.50538	.49891	.49255	.48632	.48019
80	.55728	.55028	.54340	.53665	.53002	.52351	.51712	.51083	.50466	.49860
81	.57471	.56784	.56109	.55445	.54792	.54151	.53521	.52901	.52292	.51692
82	.59186	.58512	.57850	.57199	.56558	.55927	.55307	.54697	.54097	.53506
83	.60863	.60204	.59556	.58918	.58289	.57671	.57062	.56462	.55872	.55290
84	.62505	.61862	.61228	.60604	.59989	.59383	.58786	.58198	.57618	.57047
85	.64118	.63491	.62873	.62263	.61663	.61070	.60486	.59911	.59343	.58783
86	.65685	.65075	.64473	.63879	.63294	.62716	.62145	.61583	.61027	.60479
87	.67187	.66594	.66008	.65430	.64859	.64296	.63739	.63190	.62647	.62112
88	.68631	.68054	.67485	.66923	.66367	.65818	.65276	.64740	.64211	.63688
89	.70042	.69483	.68930	.68384	.67845	.67311	.66784	.66262	.65747	.65237
90	.71434	.70894	.70359	.69830	.69307	.68790	.68278	.67772	.67271	.66775
91	.72789	.72266	.71750	.71239	.70733	.70232	.69736	.69246	.68760	.68280
92	.74070	.73567	.73068	.72574	.72085	.71601	.71121	.70647	.70176	.69711
93	.75266	.74780	.74298	.73821	.73348	.72880	.72417	.71957	.71502	.71051
94	.76363	.75893	.75428	.74967	.74510	.74057	.73608	.73163	.72722	.72285
95	.77356	.76901	.76451	.76005	.75562	.75123	.74688	.74257	.73829	.73405
96	.78237	.77797	.77360	.76927	.76497	.76071	.75648	.75229	.74813	.74401
97	.79039	.78612	.78187	.77766	.77348	.76934	.76523	.76115	.75710	.75308
98	.79762	.79345	.78932	.78522	.78115	.77711	.77310	.76913	.76518	.76126
99	.80429	.80023	.79620	.79220	.78823	.78429	.78038	.77649	.77264	.76881
100	.81047	.80651	.80258	.79867	.79479	.79094	.78712	.78332	.77955	.77580
101	.81636	.81249	.80865	.80483	.80104	.79727	.79352	.78981	.78611	.78244
102	.82250	.81872	.81497	.81124	.80754	.80386	.80020	.79656	.79295	.78936
103	.82900	.82532	.82167	.81804	.81442	.81083	.80726	.80371	.80018	.79667
104	.83622	.83266	.82911	.82558	.82207	.81858	.81510	.81165	.80821	.80479
105	.84517	.84174	.83833	.83494	.83156	.82819	.82485	.82151	.81820	.81489
106	.85814	.85494	.85175	.84857	.84540	.84225	.83911	.83598	.83286	.82975

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	8.2%	8.4%	8.6%	8.8%	9.0%	9.2%	9.4%	9.6%	9.8%	10.0%
107	.87704	.87420	.87136	.86853	.86571	.86290	.86009	.85729	.85450	.85171
108	.90812	.90593	.90375	.90156	.89939	.89721	.89504	.89286	.89070	.88853
109	.95900	.95800	.95700	.95600	.95500	.95400	.95300	.95200	.95100	.95000

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
0	.01754	.01731	.01710	.01690	.01671	.01654	.01638	.01622	.01608	.01594
1	.00630	.00607	.00585	.00565	.00547	.00530	.00514	.00499	.00485	.00472
2	.00604	.00579	.00557	.00536	.00516	.00498	.00481	.00465	.00451	.00437
3	.00604	.00578	.00554	.00532	.00511	.00492	.00474	.00458	.00442	.00427
4	.00621	.00593	.00568	.00544	.00522	.00502	.00483	.00465	.00448	.00433
5	.00648	.00619	.00592	.00567	.00544	.00522	.00502	.00483	.00465	.00449
6	.00684	.00653	.00624	.00597	.00572	.00549	.00528	.00507	.00489	.00471
7	.00726	.00693	.00663	.00634	.00608	.00583	.00560	.00539	.00518	.00499
8	.00777	.00742	.00709	.00679	.00651	.00624	.00600	.00577	.00555	.00535
9	.00837	.00800	.00765	.00733	.00703	.00675	.00649	.00625	.00602	.00580
10	.00908	.00868	.00832	.00797	.00765	.00736	.00708	.00682	.00657	.00634
11	.00991	.00949	.00910	.00874	.00840	.00808	.00779	.00751	.00725	.00700
12	.01083	.01039	.00997	.00959	.00923	.00890	.00858	.00829	.00801	.00775
13	.01181	.01134	.01090	.01049	.01012	.00976	.00943	.00912	.00883	.00855
14	.01275	.01226	.01180	.01137	.01097	.01060	.01025	.00992	.00961	.00932
15	.01365	.01313	.01264	.01219	.01177	.01138	.01101	.01066	.01034	.01003
16	.01449	.01394	.01343	.01295	.01251	.01209	.01171	.01134	.01100	.01068
17	.01526	.01469	.01415	.01365	.01318	.01274	.01233	.01195	.01159	.01125
18	.01600	.01539	.01482	.01430	.01380	.01334	.01291	.01251	.01213	.01177
19	.01673	.01609	.01550	.01494	.01442	.01393	.01348	.01305	.01265	.01227
20	.01747	.01679	.01616	.01557	.01502	.01451	.01403	.01358	.01316	.01276
21	.01820	.01748	.01682	.01620	.01562	.01508	.01457	.01409	.01365	.01323
22	.01895	.01819	.01749	.01683	.01622	.01565	.01511	.01461	.01414	.01369
23	.01972	.01893	.01818	.01749	.01684	.01624	.01567	.01514	.01464	.01417
24	.02058	.01974	.01895	.01822	.01753	.01689	.01629	.01572	.01519	.01469
25	.02154	.02064	.01981	.01903	.01830	.01762	.01698	.01638	.01582	.01529
26	.02262	.02167	.02079	.01996	.01919	.01847	.01779	.01715	.01655	.01599
27	.02385	.02284	.02191	.02103	.02021	.01944	.01872	.01804	.01740	.01680
28	.02521	.02415	.02316	.02222	.02135	.02053	.01977	.01904	.01836	.01772
29	.02673	.02561	.02455	.02357	.02264	.02177	.02095	.02018	.01946	.01877
30	.02842	.02723	.02611	.02506	.02407	.02315	.02227	.02146	.02068	.01996
31	.03030	.02903	.02784	.02673	.02568	.02470	.02377	.02290	.02207	.02130
32	.03235	.03101	.02976	.02857	.02746	.02641	.02543	.02450	.02362	.02279
33	.03463	.03321	.03188	.03062	.02944	.02833	.02728	.02629	.02535	.02447
34	.03711	.03561	.03419	.03286	.03161	.03043	.02931	.02826	.02726	.02632
35	.03981	.03822	.03672	.03531	.03398	.03273	.03154	.03042	.02936	.02836
36	.04271	.04103	.03945	.03796	.03655	.03522	.03396	.03277	.03164	.03057
37	.04584	.04407	.04239	.04081	.03932	.03791	.03657	.03531	.03411	.03297
38	.04920	.04733	.04556	.04389	.04231	.04082	.03940	.03806	.03679	.03558
39	.05280	.05083	.04897	.04721	.04554	.04396	.04246	.04103	.03968	.03840
40	.05667	.05459	.05263	.05077	.04901	.04733	.04575	.04424	.04280	.04144
41	.06080	.05861	.05655	.05459	.05272	.05096	.04928	.04768	.04617	.04472
42	.06518	.06289	.06071	.05864	.05668	.05482	.05305	.05136	.04975	.04822
43	.06982	.06742	.06513	.06296	.06089	.05893	.05706	.05528	.05358	.05196
44	.07475	.07223	.06983	.06754	.06537	.06330	.06133	.05945	.05766	.05595
45	.07998	.07733	.07481	.07242	.07014	.06796	.06588	.06390	.06202	.06021
46	.08550	.08273	.08010	.07758	.07519	.07290	.07072	.06864	.06665	.06474
47	.09134	.08845	.08569	.08306	.08055	.07815	.07586	.07367	.07157	.06957
48	.09748	.09446	.09158	.08882	.08619	.08368	.08128	.07898	.07678	.07467
49	.10391	.10076	.09775	.09487	.09212	.08949	.08697	.08456	.08225	.08003
50	.11062	.10734	.10420	.10120	.09832	.09557	.09293	.09041	.08798	.08566
51	.11764	.11423	.11096	.10783	.10483	.10195	.09919	.09655	.09401	.09158
52	.12503	.12148	.11807	.11481	.11168	.10868	.10581	.10304	.10039	.09784
53	.13278	.12909	.12556	.12216	.11891	.11578	.11278	.10989	.10712	.10445
54	.14088	.13706	.13339	.12986	.12648	.12322	.12009	.11709	.11419	.11141
55	.14936	.14540	.14159	.13793	.13442	.13103	.12778	.12464	.12163	.11872

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after APRIL 30, 1989]

Age	Adjusted payout rate									
	10.2%	10.4%	10.6%	10.8%	11.0%	11.2%	11.4%	11.6%	11.8%	12.0%
56	.15821	.15412	.15018	.14639	.14274	.13923	.13584	.13258	.12944	.12642
57	.16749	.16326	.15918	.15526	.15148	.14784	.14433	.14094	.13768	.13453
58	.17719	.17282	.16862	.16456	.16065	.15688	.15324	.14973	.14634	.14306
59	.18731	.18281	.17847	.17429	.17025	.16634	.16258	.15894	.15543	.15203
60	.19782	.19319	.18872	.18440	.18023	.17621	.17231	.16855	.16491	.16139
61	.20869	.20393	.19934	.19489	.19060	.18644	.18242	.17854	.17477	.17113
62	.21990	.21502	.21029	.20573	.20131	.19703	.19289	.18887	.18499	.18123
63	.23144	.22644	.22159	.21690	.21236	.20796	.20370	.19956	.19556	.19167
64	.24335	.23823	.23326	.22845	.22379	.21927	.21489	.21063	.20651	.20250
65	.25568	.25045	.24537	.24044	.23566	.23103	.22653	.22216	.21791	.21379
66	.26850	.26316	.25797	.25293	.24804	.24329	.23868	.23420	.22984	.22560
67	.28182	.27637	.27108	.26594	.26095	.25609	.25137	.24678	.24231	.23797
68	.29565	.29011	.28472	.27949	.27439	.26943	.26461	.25991	.25534	.25089
69	.30991	.30429	.29882	.29349	.28830	.28325	.27833	.27354	.26887	.26432
70	.32457	.31887	.31332	.30791	.30264	.29750	.29249	.28760	.28284	.27820
71	.33955	.33378	.32816	.32267	.31732	.31210	.30701	.30204	.29719	.29246
72	.35485	.34902	.34333	.33778	.33236	.32707	.32190	.31686	.31193	.30711
73	.37049	.36461	.35887	.35326	.34778	.34242	.33719	.33207	.32707	.32218
74	.38656	.38064	.37485	.36920	.36366	.35825	.35296	.34778	.34272	.33776
75	.40312	.39717	.39136	.38566	.38009	.37464	.36930	.36407	.35895	.35394
76	.42022	.41426	.40842	.40271	.39711	.39163	.38625	.38099	.37583	.37077
77	.43782	.43187	.42603	.42031	.41470	.40920	.40380	.39851	.39332	.38823
78	.45586	.44992	.44410	.43839	.43278	.42728	.42188	.41658	.41138	.40627
79	.47418	.46828	.46248	.45679	.45120	.44572	.44033	.43503	.42983	.42472
80	.49264	.48679	.48103	.47538	.46982	.46436	.45900	.45372	.44853	.44343
81	.51103	.50524	.49954	.49394	.48843	.48301	.47768	.47243	.46727	.46219
82	.52925	.52352	.51789	.51235	.50690	.50153	.49624	.49104	.48591	.48087
83	.54718	.54154	.53598	.53051	.52512	.51981	.51459	.50943	.50436	.49936
84	.56484	.55930	.55383	.54844	.54313	.53789	.53273	.52764	.52262	.51767
85	.58231	.57686	.57149	.56619	.56096	.55581	.55072	.54571	.54076	.53588
86	.59939	.59405	.58878	.58358	.57845	.57339	.56839	.56346	.55858	.55377
87	.61583	.61061	.60545	.60035	.59532	.59035	.58545	.58060	.57581	.57108
88	.63171	.62661	.62156	.61658	.61165	.60678	.60196	.59721	.59251	.58786
89	.64733	.64235	.63742	.63255	.62774	.62298	.61827	.61361	.60900	.60444
90	.66285	.65801	.65321	.64847	.64377	.63913	.63453	.62998	.62548	.62103
91	.67804	.67334	.66868	.66407	.65950	.65498	.65050	.64607	.64169	.63735
92	.69250	.68793	.68341	.67893	.67450	.67011	.66575	.66144	.65718	.65295
93	.70604	.70162	.69723	.69288	.68858	.68431	.68008	.67589	.67174	.66762
94	.71852	.71422	.70997	.70575	.70156	.69742	.69331	.68923	.68519	.68119
95	.72984	.72567	.72154	.71744	.71337	.70934	.70534	.70137	.69744	.69354
96	.73992	.73586	.73183	.72784	.72388	.71995	.71605	.71218	.70835	.70454
97	.74910	.74514	.74122	.73733	.73346	.72963	.72582	.72205	.71830	.71458
98	.75737	.75351	.74967	.74587	.74209	.73835	.73463	.73093	.72727	.72363
99	.76501	.76123	.75748	.75376	.75007	.74640	.74276	.73914	.73555	.73198
100	.77208	.76838	.76471	.76107	.75745	.75385	.75028	.74673	.74321	.73971
101	.77879	.77517	.77157	.76800	.76444	.76092	.75741	.75392	.75046	.74702
102	.78579	.78224	.77871	.77521	.77173	.76827	.76483	.76141	.75801	.75463
103	.79318	.78971	.78626	.78283	.77942	.77604	.77266	.76931	.76598	.76267
104	.80139	.79801	.79464	.79129	.78796	.78465	.78136	.77808	.77482	.77157
105	.81161	.80834	.80508	.80184	.79861	.79540	.79220	.78902	.78585	.78270
106	.82665	.82357	.82049	.81743	.81438	.81134	.80831	.80530	.80229	.79930
107	.84893	.84616	.84340	.84064	.83789	.83515	.83241	.82969	.82696	.82425
108	.88637	.88421	.88205	.87989	.87774	.87559	.87344	.87129	.86915	.86701
109	.94900	.94800	.94700	.94600	.94500	.94400	.94300	.94200	.94100	.94000

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS

[Applicable after April 30, 1989]

Age	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
0	.01581	.01569	.01557	.01546	.01536	.01526	.01516	.01507	.01499	.01490
1	.00459	.00448	.00437	.00426	.00417	.00407	.00399	.00390	.00382	.00375
2	.00424	.00412	.00400	.00389	.00379	.00369	.00360	.00352	.00343	.00335
3	.00414	.00401	.00389	.00377	.00366	.00356	.00346	.00337	.00328	.00320
4	.00418	.00404	.00391	.00379	.00368	.00357	.00347	.00337	.00327	.00319

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
5	.00433	.00418	.00405	.00391	.00379	.00368	.00357	.00346	.00336	.00327
6	.00454	.00439	.00424	.00410	.00397	.00384	.00372	.00361	.00351	.00341
7	.00482	.00465	.00449	.00434	.00420	.00407	.00394	.00382	.00371	.00360
8	.00516	.00498	.00481	.00465	.00450	.00436	.00422	.00410	.00397	.00386
9	.00560	.00541	.00523	.00505	.00489	.00474	.00459	.00446	.00433	.00420
10	.00613	.00592	.00573	.00555	.00537	.00521	.00505	.00491	.00477	.00463
11	.00677	.00655	.00635	.00615	.00597	.00580	.00563	.00547	.00532	.00518
12	.00751	.00728	.00706	.00685	.00666	.00647	.00629	.00613	.00597	.00581
13	.00829	.00805	.00782	.00760	.00739	.00719	.00701	.00683	.00666	.00650
14	.00905	.00879	.00854	.00831	.00809	.00789	.00769	.00750	.00732	.00715
15	.00974	.00947	.00921	.00897	.00874	.00852	.00831	.00811	.00793	.00775
16	.01037	.01009	.00982	.00956	.00932	.00909	.00887	.00866	.00846	.00827
17	.01093	.01063	.01034	.01007	.00982	.00958	.00935	.00913	.00892	.00873
18	.01143	.01112	.01082	.01053	.01027	.01001	.00977	.00954	.00933	.00912
19	.01192	.01159	.01127	.01097	.01069	.01043	.01017	.00993	.00970	.00949
20	.01239	.01204	.01170	.01139	.01109	.01081	.01055	.01029	.01005	.00983
21	.01283	.01246	.01211	.01178	.01147	.01117	.01089	.01063	.01037	.01013
22	.01328	.01288	.01251	.01216	.01183	.01152	.01122	.01094	.01067	.01042
23	.01372	.01331	.01292	.01254	.01219	.01186	.01155	.01125	.01097	.01070
24	.01422	.01378	.01336	.01297	.01260	.01225	.01191	.01160	.01130	.01101
25	.01479	.01432	.01388	.01346	.01306	.01269	.01233	.01200	.01168	.01138
26	.01545	.01495	.01448	.01404	.01362	.01322	.01284	.01248	.01214	.01182
27	.01623	.01570	.01520	.01472	.01427	.01385	.01344	.01306	.01270	.01235
28	.01712	.01655	.01601	.01551	.01503	.01457	.01414	.01373	.01334	.01298
29	.01813	.01752	.01695	.01641	.01589	.01541	.01494	.01451	.01409	.01370
30	.01927	.01862	.01801	.01743	.01688	.01635	.01586	.01539	.01495	.01452
31	.02056	.01987	.01922	.01859	.01801	.01745	.01692	.01642	.01594	.01548
32	.02201	.02127	.02057	.01990	.01927	.01868	.01811	.01757	.01706	.01657
33	.02363	.02284	.02209	.02138	.02071	.02007	.01946	.01888	.01833	.01781
34	.02543	.02458	.02378	.02302	.02230	.02162	.02096	.02034	.01975	.01919
35	.02741	.02651	.02565	.02484	.02407	.02333	.02264	.02197	.02134	.02073
36	.02956	.02859	.02768	.02681	.02599	.02520	.02446	.02374	.02307	.02242
37	.03189	.03087	.02990	.02897	.02809	.02725	.02645	.02569	.02496	.02427
38	.03443	.03334	.03230	.03131	.03037	.02948	.02862	.02781	.02703	.02628
39	.03718	.03602	.03491	.03386	.03285	.03190	.03099	.03011	.02928	.02849
40	.04015	.03891	.03774	.03662	.03555	.03453	.03355	.03262	.03173	.03088
41	.04335	.04204	.04079	.03959	.03846	.03737	.03633	.03534	.03439	.03348
42	.04677	.04538	.04405	.04278	.04157	.04042	.03931	.03825	.03724	.03627
43	.05042	.04894	.04754	.04619	.04491	.04368	.04250	.04138	.04030	.03926
44	.05432	.05276	.05127	.04984	.04848	.04718	.04593	.04473	.04358	.04248
45	.05849	.05684	.05526	.05375	.05231	.05092	.04960	.04832	.04710	.04593
46	.06292	.06118	.05952	.05792	.05639	.05492	.05352	.05217	.05087	.04963
47	.06765	.06581	.06405	.06237	.06075	.05920	.05771	.05628	.05491	.05359
48	.07265	.07071	.06886	.06708	.06537	.06373	.06216	.06064	.05919	.05779
49	.07791	.07587	.07392	.07204	.07024	.06851	.06685	.06525	.06371	.06223
50	.08343	.08129	.07923	.07726	.07536	.07354	.07178	.07009	.06847	.06690
51	.08924	.08699	.08483	.08276	.08076	.07884	.07699	.07520	.07349	.07183
52	.09539	.09303	.09076	.08858	.08648	.08446	.08251	.08064	.07883	.07708
53	.10189	.09942	.09704	.09475	.09255	.09043	.08838	.08640	.08450	.08266
54	.10872	.10614	.10365	.10126	.09894	.09672	.09456	.09249	.09049	.08855
55	.11592	.11322	.11062	.10811	.10569	.10335	.10110	.09892	.09682	.09478
56	.12350	.12068	.11796	.11534	.11281	.11036	.10800	.10571	.10350	.10137
57	.13148	.12855	.12572	.12298	.12033	.11777	.11530	.11291	.11060	.10836
58	.13990	.13685	.13389	.13104	.12828	.12561	.12303	.12053	.11811	.11576
59	.14875	.14557	.14250	.13953	.13665	.13387	.13118	.12856	.12604	.12359
60	.15799	.15469	.15150	.14841	.14542	.14253	.13972	.13700	.13436	.13180
61	.16761	.16419	.16088	.15768	.15457	.15156	.14864	.14580	.14305	.14039
62	.17758	.17404	.17062	.16729	.16407	.16094	.15791	.15496	.15210	.14932
63	.18791	.18425	.18071	.17726	.17392	.17068	.16753	.16447	.16150	.15861
64	.19862	.19484	.19118	.18762	.18417	.18081	.17754	.17437	.17129	.16829
65	.20979	.20590	.20212	.19845	.19487	.19140	.18802	.18474	.18154	.17843
66	.22149	.21748	.21359	.20980	.20612	.20253	.19904	.19564	.19233	.18911
67	.23374	.22962	.22562	.22172	.21792	.21423	.21062	.20712	.20370	.20037
68	.24656	.24234	.23822	.23422	.23031	.22651	.22280	.21919	.21566	.21222
69	.25988	.25556	.25134	.24724	.24323	.23932	.23551	.23179	.22816	.22461
70	.27367	.26925	.26493	.26073	.25662	.25261	.24870	.24488	.24115	.23750
71	.28784	.28333	.27892	.27462	.27042	.26631	.26230	.25839	.25456	.25082
72	.30241	.29781	.29332	.28893	.28464	.28044	.27634	.27233	.26841	.26457

TABLE U(1)—BASED ON LIFE TABLE 80CNSMT UNITRUST SINGLE LIFE REMAINDER FACTORS—Continued

[Applicable after April 30, 1989]

Age	Adjusted payout rate									
	12.2%	12.4%	12.6%	12.8%	13.0%	13.2%	13.4%	13.6%	13.8%	14.0%
73	.31740	.31272	.30815	.30368	.29930	.29502	.29084	.28674	.28273	.27880
74	.33291	.32817	.32352	.31897	.31452	.31016	.30589	.30171	.29762	.29361
75	.34903	.34422	.33951	.33490	.33038	.32595	.32161	.31735	.31318	.30909
76	.36581	.36095	.35619	.35152	.34694	.34245	.33805	.33373	.32949	.32533
77	.38324	.37835	.37354	.36883	.36420	.35966	.35520	.35083	.34654	.34232
78	.40126	.39634	.39150	.38676	.38210	.37752	.37302	.36861	.36427	.36001
79	.41970	.41476	.40992	.40515	.40047	.39587	.39135	.38690	.38253	.37823
80	.43842	.43348	.42864	.42387	.41918	.41456	.41002	.40556	.40117	.39685
81	.45719	.45228	.44744	.44267	.43799	.43337	.42883	.42436	.41996	.41562
82	.47590	.47101	.46619	.46145	.45677	.45217	.44764	.44317	.43877	.43443
83	.49443	.48957	.48478	.48007	.47542	.47084	.46632	.46187	.45748	.45315
84	.51279	.50798	.50324	.49856	.49394	.48939	.48490	.48048	.47611	.47180
85	.53106	.52630	.52161	.51698	.51241	.50790	.50345	.49906	.49473	.49045
86	.54902	.54434	.53971	.53514	.53062	.52616	.52176	.51741	.51312	.50888
87	.56640	.56178	.55722	.55271	.54826	.54386	.53951	.53521	.53097	.52677
88	.58326	.57872	.57423	.56979	.56541	.56107	.55678	.55254	.54834	.54420
89	.59994	.59548	.59107	.58671	.58240	.57813	.57391	.56973	.56560	.56152
90	.61662	.61226	.60794	.60367	.59944	.59526	.59112	.58702	.58296	.57894
91	.63305	.62879	.62457	.62040	.61627	.61217	.60812	.60411	.60013	.59619
92	.64876	.64461	.64050	.63643	.63239	.62839	.62443	.62051	.61662	.61277
93	.66355	.65950	.65550	.65153	.64759	.64369	.63983	.63600	.63220	.62843
94	.67722	.67328	.66938	.66551	.66167	.65786	.65409	.65035	.64664	.64296
95	.68967	.68583	.68203	.67825	.67451	.67079	.66711	.66345	.65983	.65623
96	.70076	.69701	.69330	.68961	.68595	.68231	.67871	.67513	.67158	.66806
97	.71089	.70722	.70359	.69998	.69640	.69284	.68931	.68581	.68234	.67888
98	.72001	.71642	.71286	.70933	.70582	.70233	.69887	.69544	.69203	.68864
99	.72844	.72492	.72143	.71796	.71452	.71110	.70770	.70433	.70098	.69765
100	.73623	.73278	.72935	.72594	.72256	.71920	.71586	.71254	.70924	.70597
101	.74361	.74021	.73684	.73349	.73016	.72685	.72356	.72029	.71704	.71382
102	.75128	.74794	.74463	.74133	.73806	.73480	.73157	.72835	.72515	.72198
103	.75938	.75610	.75284	.74961	.74639	.74319	.74000	.73684	.73369	.73056
104	.76835	.76514	.76194	.75877	.75561	.75246	.74934	.74623	.74313	.74005
105	.77956	.77643	.77332	.77023	.76714	.76408	.76102	.75798	.75496	.75195
106	.79632	.79334	.79038	.78743	.78449	.78157	.77865	.77575	.77285	.76997
107	.82154	.81884	.81615	.81346	.81079	.80811	.80545	.80279	.80014	.79750
108	.86487	.86274	.86061	.85848	.85635	.85423	.85210	.84998	.84787	.84575
109	.93900	.93800	.93700	.93600	.93500	.93400	.93300	.93200	.93100	.93000

[T.D. 8540, 59 FR 30102, 30116, 30117, 30148, June 10, 1994, as amended by T.D. 8819, 64 FR 23199, 23209, Apr. 30, 1999; T.D. 8886, 65 FR 36943, June 12, 2000]

TREATMENT OF EXCESS DISTRIBUTIONS OF TRUSTS APPLICABLE TO TAXABLE YEARS BEGINNING ON OR AFTER JANUARY 1, 1969

§ 1.665(a)–0A Excess distributions by trusts; scope of subpart D.

(a) *In general.* (1) Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code as amended by the Tax Reform Act of 1969, is designed to tax the beneficiary of a trust that accumulates, rather than distributes, all or part of its income currently (i.e., an accumulation trust), in most cases, as if the income had been currently distributed to the beneficiary instead of accumulated by the trusts. Accordingly, subpart D provides special rules for the treatment of amounts paid, credited, or required to be distributed by a complex trust (one that is subject to subpart C (section 661 and following) of such part I) in any year in excess of ''distributable net income'' (as defined in section 643 (a)) for that year. Such an excess distribution is an ''accumulation distribution'' (as defined in section 665(b)). The special rules of subpart D are generally inapplicable to amounts paid, credited, or required to be distributed by a trust in a taxable year in which it qualifies as a simple trust (one that is subject to subpart B (section 651 and following) of such part I). However, see § 1.665(e)–1A(b) for rules relating to the treatment of a simple trust as a complex trust.

(2) An accumulation distribution is deemed to consist of, first, ''undistributed net income'' (as defined in section 665(a)) of the trust from preceding taxable years, and, after all the undistributed net income for all preceding taxable years has been deemed distributed, ''undistributed capital gain'' (as defined in section 665(f)) of the trust for all preceding taxable years commencing with the first year such amounts were accumulated. An accumulation distribution of undistributed capital gain is a ''capital gain distribution'' (as defined in section 665(g)). To the extent an accumulation distribution exceeds the ''undistributed net income'' and ''undistributed capital gain'' so determined, it is deemed to consist of corpus.

(3) The accumulation distribution is ''thrown back'' to the earliest ''preceding taxable year'' of the trust, which, in the case of distributions made for a taxable year beginning after December 31, 1973, from a trust (other than a foreign trust created by a U.S. person), is any taxable year beginning after December 31, 1968. Special transitional rules apply for distributions made in taxable years beginning before January 1, 1974. In the case of a foreign trust created by a U.S. person, a ''preceding taxable year'' is any year of the trust to which the Code applies.

(4) A distribution of undistributed net income (included in an accumulation distribution) and a capital gain distribution will be included in the income of the beneficiary in the year they are actually paid, credited, or required to be distributed to him. The tax on the distribution will be approximately the amount of tax the beneficiary would have paid with respect to the distribution had the income and capital gain been distributed to the beneficiary in the year earned by the trust. An additional amount equal to the ''taxes imposed on the trust'' for the preceding year is also deemed distributed. To prevent double taxation, however, the beneficiary receives a credit for such taxes.

(b) *Effective dates.* All regulations sections under subpart D (sections 665 through 669) which have an ''A'' suffix (such as § 1.665(a)A and § 1.666(b)–1A) are applicable to taxable years beginning on or after January 1, 1969, and all references therein to sections 665 through 669 are references to such sections as amended by the Tax Reform Act of 1969. Sections without the ''A'' suffix (such as § 1.666(b)–1) are applicable only to taxable years beginning before January 1, 1969, and all references therein to sections 665 through 669 are references to such sections before amendment by the Tax Reform Act of 1969.

(c) *Examples.* Where examples contained in the regulations under subpart D refer to tax rates for years after 1968, such tax rates are not necessarily the actual rates for such years, but are only used for example purposes.

(d) *Applicability to estates.* Subpart D does not apply to any estate.

[T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§ 1.665(a)–1A Undistributed net income.

(a) *Domestic trusts.* The term *undistributed net income,* in the case of a trust (other than a foreign trust created by a U.S. person) means, for any taxable year beginning after December 31, 1968, the distributable net income of the trust for that year (as determined under section 643(a)), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on the trust attributable to such distributable net income, as defined in § 1.665(d)–1A. The application of the rule in this paragraph to a taxable year of a trust in which income is accumulated may be illustrated by the following example:

Example. Under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1971 the trust had distributable net income of $30,100 derived from royalties and the trustee made distributions of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,190 is paid. The undistributed net income of the trust for the taxable year 1971 is $7,910, computed as follows:

Distributable net income	$30,100

Less:	
Income currently distributable to A	$10,000
Other amounts distributed to A	10,000
Taxes imposed on the trust attributable to the undistributed net income (see § 1.665(d)–1A)	2,190
Total	22,190
Undistributed net income	7,910

(b) *Foreign trusts.* The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see § 1.643(a)–6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on such trust by chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income.

For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust for any taxable year by chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to section 871 (relating to tax on non-resident alien individuals) which is properly allocable to the undistributed portion of the distributable net income. See § 1.665(d)–1A. The amount of taxes imposed pursuant to section 871 is the difference between the total tax imposed pursuant to that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in this paragraph may be illustrated by the following examples:

Example 1. A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that $7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1973 the trust had income of $10,000 from dividends of a U.S. corporation (on which Federal income taxes of $3,000 were imposed pursuant to section 871 and withheld under section 1441, resulting in the receipt by the trust of cash in the amount of $7,000), $20,000 in capital gains from the sale of stock of a Country Y corporation and $30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. No income taxes were required to be paid to Country X or Country Y in 1973. The trustee did not file a U.S. income tax return for the taxable year 1973. The distributable net income of the trust before distributions to the beneficiary for 1973 is $60,000 ($57,000 of which is cash). During 1973 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income. Thus, the U.S. beneficiary is treated as having had distributed to him $5,000 (composed of $3,500 as a cash distribution and $1,500 as the tax imposed pursuant to section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; $10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and $15,000 in cash, representing one-half of the income from Country X sources for a total of $30,000. The undistributed net income of the trust at the close of taxable year 1973 is $28,500 computed as follows:

Distributable net income	$60,000
Less:	
(1) Amounts distributed to the beneficiary:	
Income currently distributed to the beneficiary	$7,000
Other amounts distributed to the beneficiary	21,500
Taxes under sec. 871 deemed distributed to the beneficiary	1,500
Total amounts distributed to the beneficiary	80,000
(2) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See § 1.665 (d)–1A) $3,000 less $1,500)	$1,500
Total	$31,500
Undistributed net income	28,500

Example 2. The facts are the same as in example 1 except that property has been transferred to the trust by a person other than a U.S. person, and during 1973 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X or Country Y in 1973.

(1) The undistributed net income of the portion of the entire trust which is a foreign

trust created by a U.S. person for 1973 is $17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):		
60% of $10,000 U.S. dividends		$6,000
60% of $20,000 Country X capital gains		12,000
60% of $30,000 Country X dividends		18,000
Total		36,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (60% of $7,000)	$4,200	
Other amounts distributed to the beneficiary (60% of $21,500)	12,900	
Taxes under sec. 871 deemed distributed to the beneficiary (60% of $1,500)	900	
Total amounts distributed to the beneficiary	18,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (see § 1.665 (d)–1A) (60% of $1,500)	900	
Total		18,900
Undistributed net income		17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1973 is $11,400, computed as follows:

Distributable net income (40% of each item of gross income of entire trust)		
40% of $10,000 U.S. dividends		$4,000
40% of $20,000 Country X capital gains		8,000
40% of $30,000 Country X dividends		12,000
Total		24,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (40% of $7,000)	$2,800	
Other amounts distributed to the beneficiary (40% of $21,500)	8,600	
Taxes under sec. 871 deemed distributed to the beneficiary (40% of $1,500)	600	
Total amounts distributed to the beneficiary	12,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See § 1.665 (d)–1A) (40% of $1,500)	600	
Total		12,600
Undistributed net income		11,400

(c) *Effect of prior distributions.* The undistributed net income for any year to which an accumulation distribution for a later year may be thrown back will be reduced by accumulation distributions in intervening years that are required to be thrown back to such year. For example, if a trust has undistributed net income for 1975, and an accumulation distribution is made in 1980, there must be taken into account the effect on undistributed net income for 1975 of any accumulation distribution made in 1976, 1977, 1978, or 1979. However, undistributed net income for any year will not be reduced by any distributions in any intervening years that are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (d) of § 1.666(a)–1A for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

(d) *Distributions made in taxable years beginning before January 1, 1974.* For special rules relating to accumulation distributions of undistributed net income made in taxable years of the trust beginning before January 1, 1974, see § 1.665(b)–2A.

[T.D. 7204, 37 FR 17136, Aug. 25, 1972]

§ 1.665(b)–1A Accumulation distributions.

(a) *In general.* (1) For any taxable year of a trust the term *accumulation distribution* means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) (*i.e.*, all amounts properly paid, credited, or required to be distributed to the beneficiary other than income required to be distributed currently within the meaning of section 661(a)(1)) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. To the extent provided in section 663(b) and the regulations thereunder, distributions made within the first 65 days following a taxable year may be treated as having been distributed on the last day of such taxable year.

(2) An accumulation distribution also includes, for a taxable year of the trust, any amount to which section 661(a)(2) and the preceding paragraph are inapplicable and which is paid, credited, or required to be distributed during the taxable year of the trust by

reason of the exercise of a power to appoint, distribute, consume, or withdraw corpus of the trust or income of the trust accumulated in a preceding taxable year. No accumulation distribution is deemed to be made solely because the grantor or any other person is treated as owner of a portion of the trust by reason of an unexercised power to appoint, distribute, consume, or withdraw corpus or accumulated income of the trust. Nor will an accumulation distribution be deemed to have been made by reason of the exercise of a power that may affect only taxable income previously attributed to the holders of such power under subpart E (section 671 and following). See example 4 of paragraph (d) of this section for an example of an accumulation distribution occurring as a result of the exercise of a power of withdrawal.

(3) Although amounts properly paid or credited under section 661(a) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if the amounts properly paid or credited under section 661(a)(2) exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently under section 661(a)(1). This may occur, for example, when expenses, interest, taxes, or other items allocable to corpus are taken into account in determining taxable income and hence causing distributable net income to be less than the trust's income.

(b) *Payments that are accumulation distributions.* The following are some instances in which an accumulation distribution may arise:

(1) *One trust to another.* A distribution from one trust to another trust is generally an accumulation distribution. See §1.643(c)–1. This general rule will apply regardless of whether the distribution is to an existing trust or to a newly created trust and regardless of whether the trust to which the distribution is made was created by the same person who created the trust from which the distribution is made or a different person. However, a distribution made from one trust to a second trust will be deemed an accumulation distribution by the first trust to an ultimate beneficiary of the second trust if the primary purpose of the distribution to the second trust is to avoid the capital gain distribution provisions (see section 669 and the regulations thereunder). An amount passing from one separate share of a trust to another separate share of the same trust is not an accumulation distribution. See §1.665(g)–2A. For rules relating to the computation of the beneficiary's tax under section 668 by reason of an accumulation distribution from the second trust, see paragraphs (b)(1) and (c)(1)(i) of §1.668(b)–1A and paragraphs (b)(1) and (c)(1)(i) of §1.669(b)–1A.

(2) *Income accumulated during minority.* A distribution of income accumulated during the minority of the beneficiary is generally an accumulation distribution. For example, if a trust accumulates income until the beneficiary's 21st birthday, and then distributes the income to the beneficiary, such a distribution is an accumulation distribution. However, see §1.665(b)–2A for rules governing income accumulated in taxable years beginning before January 1, 1969.

(3) *Amounts paid for support.* To the extent that amounts forming all or part of an accumulation distribution are applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) or are used to discharge or satisfy any person's legal obligation as that term is used in §1.662(a)–4, such amounts will be considered as having been distributed directly to the person whose obligation is being satisfied.

(c) *Payments that are not accumulation distributions*—(1) *Gifts, bequests, etc., described in section 663(a)(1).* A gift or bequest of a specific sum of money or of specific property described in section 663(a)(1) is not an accumulation distribution.

(2) *Charitable payments.* Any amount paid, permanently set aside, or used for the purposes specified in section 642(c) is not an accumulation distribution, even though no charitable deduction is allowed under such section with respect to such payment.

(3) *Income required to be distributed currently.* No accumulation distribution

will arise by reason of a payment of income required to be distributed currently even though such income exceeds the distributable net income of the trust because the payment is an amount specified in section 661(a)(1).

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

Example 1. A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1976, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows.

Total distribution		$20,000
Less: Income required to be distributed currently (section 661(a)(1))		10,000
Other amounts distributed (section 661(a)(2))		10,000
Distributable net income	$15,000	
Less: Income required to be distributed currently	10,000	
Balance of distributable net income		5,000
Accumulation distribution		5,000

Example 2. Under the terms of the trust instrument, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643(b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and, in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))		15,000
Other amounts distributed (section 661(a)(2))		5,000
Distributable net income	$13,000	
Less: Income required to be distributed currently to A	15,000	
Balance of distributable net income		0
Accumulation distribution to B		5,000

Example 3. Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently		0
Other amounts distributed (section 661(a)(2))		20,000
Distributable net income	$17,000	
Less: Income required to be distributed currently	0	
Balance of distributable net income		17,000
Accumulation distribution		3,000

Example 4. A dies in 1974 and bequeaths one-half the residue of his estate in trust. His widow, W, is given a power, exercisable solely by her, to require the trustee to pay her each year of the trust $5,000 from corpus. W's right to exercise such power was exercisable at any time during the year but was not cumulative, so that, upon her failure to exercise it before the end of any taxable year of the trust, her right as to that year lapsed. The trust's taxable year is the calendar year. During the calendar years 1975 and 1976, W did not exercise her right and it lapsed as to those years. In the calendar years 1977 and 1978, in which years the trust had not distributable net income, she exercised her right and withdrew $4,000 in 1977 and $5,000 in 1978. No accumulation distribution was made by the trust in the calendar years 1975 and 1976. An accumulation distribution of $4,000 was made in 1977 and an accumulation distribution of $5,000 was made in 1978. The accumulation distribution for the years 1977 and 1978 is not reduced by any amount of income of the trust attributable to her under section 678 by reason of her power of withdrawal.

[T.D. 7204, 37 FR 17137, Aug. 25, 1972]

§ 1.665(b)–2A Special rules for accumulation distributions made in taxable years beginning before January 1, 1974.

(a) *General rule.* Section 331(d)(2)(A) of the Tax Reform Act of 1969 excludes certain accumulated income from the tax imposed by section 668(a)(2) by providing certain exceptions from the definition of an ''accumulation distribution.'' Any amount paid, credited, or required to be distributed by a trust (other than a foreign trust created by a U.S. person) during a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, shall not be subject to the tax imposed by section 668(a)(2) to the extent of the portion of such amount that (1) would be allocated under section 666(a) to a preceding taxable year of the trust beginning before January 1, 1969, and (2) would not have been deemed an accumulation distribution because of the provisions of paragraphs (1), (2), (3), or (4) of section 665(b) as in effect on December 31, 1968, had the trust distributed such amounts on the last day of its last taxable year beginning before January 1, 1969. However, the $2,000 *de minimis* exception formerly in section 665(b) does not apply in the case of any distribution made in a taxable year of a trust beginning after December 31, 1968. Amounts to which this exclusion applies shall reduce the undistributed net income of the trust for the preceding taxable year or years to which such amounts would be allocated under section 666(a). However, since section 668(a)(2) does not apply to such amounts, no amount of taxes imposed on the trust allocable to such undistributed net income is deemed distributed under section 666 (b) and (c).

(b) *Application of general rule.* The rule expressed in paragraph (a) of this section is applied to the exceptions formerly in section 665(b) as follows:

(1) *Distributions from amounts accumulated while beneficiary is under 21.* (i) Paragraph (1) of section 665(b) as in effect on December 31, 1968, provided that amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21 were not to be considered to be accumulation distributions. If an accumulation distribution is made in a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) to the extent the income earned by the trust for such preceding taxable year would be deemed under §1.665(b)–2(b)(1) to have been accumulated before the beneficiary's birth or before his 21st birthday. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on the calendar year basis was established on January 1, 1965, to accumulate the income during the minority of B, and to pay the accumulated income over to B upon his attaining the age of 21. B's 21st birthday is January 1, 1973. On January 2, 1973, the trustee pays over to B all the accumulated income of the trust. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in §1.665(e)–1A). To the extent the distribution is allocated to 1968, no tax is imposed under section 668(a)(2).

(ii) As indicated in paragraph (a) of this section, a distribution of an amount excepted from the tax otherwise imposed under section 668(a)(2) will reduce undistributed net income for the purpose of determining the effect of a future distribution. Thus, under the facts of the example in subdivision (i) of this subparagraph, the undistributed net income for the trust's taxable year 1968 would be reduced by the amount of the distribution allocated to that year under section 666(a).

(2) *Emergency distributions.* Paragraph (2) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary to meet his emergency needs. Therefore, if an accumulation distribution is made from a trust in a taxable year beginning before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) if such distribution would have been considered an emergency distribution under §1.665(b)–2(b)(2) had it been made in a taxable year of the trust beginning before January 1, 1969. For example, assume a trust on a calendar year basis in 1972 makes an accumulation distribution which under §1.665(b)–2(b) (2) would be considered an emergency distribution and under section 666(a) the distribution would be allocated to the years 1967, 1968, and 1969. To the extent such amount is allocated to 1967 and 1968, no tax would be imposed under section 668(a)(2).

(3) *Certain distributions at specified ages.* Paragraph (3) of section 665(b) as in effect on December 31, 1968, provided an exclusion (in the case of certain trusts created before January 1, 1954) from the definition of an accumulation distribution for amounts properly paid

or credited to a beneficiary upon his attaining a specified age or ages, subject to certain restrictions (see § 1.665(b)–2(b)(3)). Therefore, a distribution from a trust in a taxable year beginning after December 31, 1968, will not be subject to the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such distribution would have qualified under the provisions of § 1.665(b)–2(b)(3) had it been made in a taxable year of the trust to which such section was applicable.

(4) *Certain final distributions.* Paragraph (4) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution was made more than 9 years after the date of the last transfer to such trust. Therefore, amounts properly paid or credited to a beneficiary as a final distribution of a trust in a taxable year of a trust beginning after December 31, 1968, and before January 1, 1974, will not be subject to the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such final distribution was made more than 9 years after the date of the last transfer to such trust. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on a calendar year basis was established on January 1, 1958, and no additional transfers were made to it. On January 1, 1973, the trustee terminates the trust and on the same day he makes a final distribution to the beneficiary, B. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in § 1.665(e)–1A). Because more than 9 years elapsed between the date of the last transfer to the trust and the date of final distribution, the distribution is not taxed under section 668 (a) (2) to the extent it would be allocated to 1968 under section 666(a).

[T.D. 7204, 37 FR 17138, Aug. 25, 1972]

§ 1.665(c)–1A Special rule applicable to distributions by certain foreign trusts.

(a) *In general.* Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) *Limitation.* In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

[T.D. 7204, 37 FR 17139 Aug. 25, 1972]

§ 1.665(d)–1A Taxes imposed on the trust.

(a) *In general.* (1) For purposes of subpart D, the term *taxes imposed on the trust* means the amount of Federal income taxes properly imposed for any taxable year on the trust that are attributable to the undistributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. Except as provided in paragraph (c)(2) of this section, the minimum tax for tax preferences imposed by section 56 is not a tax attributable to the undistributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. See section 56 and the regulations thereunder.

(2) In the case of a trust that has received an accumulation distribution from another trust, the term *taxes imposed on the trust* also includes the amount of taxes deemed distributed under §§ 1.666(b)–1A, 1.666(c)–1A, 1.669(d)–1A, and 1.669(e)–1A (whichever are applicable) as a result of such accumulation distribution, to the extent that they were taken into account under paragraphs (b)(2) or (c)(1)(vi) of § 1.668 (b)–1A and (b)(2) or (c)(1)(vi) of § 1.669(b)–1A in computing the partial tax on such accumulation distribution. For example, assume that trust A, a calendar year trust, makes an accumulation distribution in 1975 to trust B, also on the calendar year basis, in connection with which $500 of taxes are deemed under § 1.666(b)–1A to be distributed to trust B. The partial tax on the accumulation distribution is computed under paragraph (b) of § 1.668(b)–1A (the exact method) to be $600 and all of the $500 is used under paragraph (b)(2) of § 1.668(b)–1A to reduce the partial tax to $100. The taxes imposed on trust B for 1975 will, in addition to the $100 partial tax, also include the $500 used to reduce the partial tax.

(b) *Taxes imposed on the trust attributable to undistributed net income.* (1) For the purpose of subpart D, the term *taxes imposed on the trust attributable to the undistributed net income* means the amount of Federal income taxes for the taxable year properly allocable to the undistributed portion of the distributable net income for such taxable year. This amount is (i) an amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax for tax preferences imposed by section 56), computed after the allowance of credits under section 642(a), as *(a)* the taxable income of the trust, other than the capital gains not included in distributable net income less their share of section 1202 deduction, bears to *(b)* the total taxable income of the trust for such year or, (ii) if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, an amount equal to such total taxes less the amount of the alternative tax imposed on the trust and attributable to the capital gain. Thus, for the purposes of subpart D, in determining the amount of taxes imposed on the trust attributable to the undistributed net income, that portion of the taxes paid by the trust attributable to capital gain allocable to corpus is excluded. The rule stated in this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. (1) Under the terms of a trust, which reports on the calendar year basis, the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1974, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribution of $10,000 to A. The taxes imposed on the trust for such year attributable to the undistributed net income are $2,319, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is $18,000 (royalties of $20,000 less expenses of $2,000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gain allocable to corpus		10,000
Gross income		30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		12,900
Total income taxes		3,787

(3) Taxable income other than capital gains less the section 1202 deduction is $7,900

($12,900 − ($10,000 − $5,000)). Therefore, the amount of taxes imposed on the trust attributable to the undistributed net income is $2,319, computed as follows:

$3,787 (total taxes) × $7,900 (taxable income other than capital gains not included in d.n.i. less the 1202 deduction) divided by $12,900 (taxable income)	$2,319

(2) If in any taxable year an accumulation distribution of undistributed net income is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed net income of such prior year are the taxes prescribed in subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 666 (b) or (c). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1975 the trust makes an accumulation distribution, of which an amount of undistributed net income is deemed distributed in 1974. Taxes imposed on the trust (in the amount of $1,000) attributable to the undistributed net income are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust subsequent to the 1975 distribution attributable to the remaining undistributed net income are $1,319 ($2,319 less $1,000).

(c) *Taxes imposed on the trust attributable to undistributed capital gain*—(1) *Regular tax.* For the purpose of subpart D the term *taxes imposed on the trust attributable to undistributed capital gain* means the amount of Federal income taxes for the taxable year properly attributable to that portion of the excess of capital gains over capital losses of the trust that is allocable to corpus for such taxable year. Such amount is the total of:

(i) The amount computed under subparagraph (2) of this paragraph (the minimum tax), plus

(ii) The amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax), computed after the allowance of credits under section 642(a), as *(a)* the excess of capital gains over capital losses for such year that are not included in distributable net income, computed after its share of the deduction under section 1202 (relating to the deduction for capital gains) has been taken into account, bears to the greater of *(b)* the total taxable income of the trust for such year, or *(c)* the amount of capital gains computed under *(a)* of this subdivision.

However, if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, the amount is the amount of the alternative tax imposed on the trust and attributable to the capital gain. The application of this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. Assume the same facts as in the example in paragraph (b)(1). The capital gains not included in d.n.i. are $10,000, and the deduction under section 1202 is $5,000. The amount of taxes imposed on the trust attributable to undistributed capital gain is $1,468, computed as follows:

$3,787 (total taxes) × $5,000 (capital gains not included in d.n.i. less section 1202 deductions) divided by $12,900 (taxable income)	$1,468

(2) *Minimum tax.* The term *taxes imposed on the trust attributable to the undistributed capital gain* also includes the minimum tax for tax preferences imposed on the trust by section 56 with respect to the undistributed capital gain. The amount of such minimum tax so included bears the same relation to the total amount of minimum tax imposed on the trust by section 56 for the taxable year as one-half the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) from such taxable year bears to the sum of the items of tax preference of the trust for such taxable year which are apportioned to the trust in accordance with § 1.58–3(a) (1).

(3) *Reduction for prior distribution.* If in any taxable year a capital gain distribution is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed capital gain of the prior year are the taxes prescribed in subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 669 (d) or (e). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1976, the trust makes a capital gain distribution, of which an amount of undistributed capital gain is deemed distributed in 1974. Taxes imposed on the trust (in the amount of $500) attributable to the undistributed capital gain are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust attributable to the remaining undistributed capital gain are $968 ($1,468 less $500).

[T.D. 7204, 37 FR 17139, Aug. 25, 1972, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.665(e)–1A Preceding taxable year.

(a) *Definition*—(1) *Domestic trusts*— (i) *In general.* For purposes of subpart D, in the case of a trust other than a foreign trust created by a U.S. person, the term *preceding taxable year* serves to identify and limit the taxable years of a trust to which an accumulation distribution consisting of undistributed net income or undistributed capital gain may be allocated (or ''thrown back'') under section 666(a) and 669(a). An accumulation distribution consisting of undistributed net income or undistributed capital gain may not be allocated or ''thrown back'' to a taxable year of a trust if such year is not a ''preceding taxable year.''

(ii) *Accumulation distributions.* In the case of an accumulation distribution consisting of undistributed net income made in a taxable year beginning before January 1, 1974, any taxable year of the trust that precedes by more than 5 years the taxable year of the trust in which such accumulation distribution was made is not a ''preceding taxable year.'' Thus, for a domestic trust on a calendar year basis, calendar year 1967 is not a ''preceding taxable year'' with respect to an accumulation distribution made in calendar year 1973, whereas calendar year 1968 is a ''preceding taxable year.'' In the case of an accumulation distribution made during a taxable year beginning after December 31, 1973, any taxable year of the trust that begins before January 1, 1969, is not a ''preceding taxable year.'' Thus, for a domestic trust on a calendar year basis, calendar year 1968 is not a ''preceding taxable year'' with respect to an accumulation distribution made in calendar year 1975, whereas calendar year 1969 is a ''preceding taxable year.''

(iii) *Capital gain distributions.* In the case of an accumulation distribution that is a capital gain distribution, any taxable year of the trust that *(a)* begins before January 1, 1969, or *(b)* is prior to the first year in which income is accumulated, whichever occurs later, is not a ''preceding taxable year.'' Thus, for the purpose of capital gain distributions and section 669, only taxable years beginning after December 31, 1968, can be ''preceding taxable years.'' See § 1.688(a)–1A(c).

(2) *Foreign trusts created by U.S. persons.* For purposes of subpart D, in the case of a foreign trust created by a U.S. person, the term ''preceding taxable year'' does not include any taxable year to which part I of subchapter J does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of subpart D may not, in the case of a foreign trust created by a U.S. person, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a foreign trust created by a U.S. person (reporting on the calendar year basis) makes a distribution during the calendar year 1970 of income accumulated during prior years, the earliest year of the trust to which the accumulation distribution may be allocated under such subpart D is 1954, but it may not be allocated to 1953 and prior years, since the Internal Revenue Code of 1939 applies to those years.

(b) *Simple trusts.* A taxable year of a trust during which the trust was a simple trust (that is, was subject to subpart B) for the entire year shall not be considered a ''preceding taxable year'' unless during such year the trust received ''outside income'' or unless the trustee did not distribute all of the income of the trust that was required to be distributed currently for such year. In such event, undistributed net income for such year shall not exceed the greater of the ''outside income'' or income not distributed during such year. For purposes of this paragraph, the term *outside income* means amounts that are included in distributable net income of the trust for the year but that are not ''income'' of the trust as that term is defined in § 1.643(b)–1.

Some examples of ''outside income'' are:

(1) Income taxable to the trust under section 691;

(2) Unrealized accounts receivable that were assigned to the trust; and

(3) Distributions from another trust that include distributable net income or undistributed net income of such other trust.

The term *outside income,* however, does not include amounts received as distributions from an estate, other than income specified in (1) and (2), for which the estate was allowed a deduction under section 661(a). The application of this paragraph may be illustrated by the following examples:

Example 1. By his will D creates a trust for his widow W. The terms of the trust require that the income be distributed currently (i.e., it is a simple trust), and authorize the trustee to make discretionary payments of corpus to W. Upon W's death the trust corpus is to be distributed to D's then living issue. The executor of D's will makes a $10,000 distribution of corpus to the trust that carries out estate income consisting of dividends and interest to the trust under section 662(a)(2). The trust reports this income as its only income on its income tax return for its taxable year in which ends the taxable year of the estate in which the $10,000 distribution was made, and pays a tax thereon of $2,106. Thus, the trust has undistributed net income of $7,894 ($10,000 −$2,106). Several years later the trustee makes a discretionary corpus payment of $15,000 to W. This payment is an accumulation distribution under section 665(b). However, since the trust had no ''outside income'' in the year of the estate distribution, such year is not a preceding taxable year. Thus, W is not treated as receiving undistributed net income of $7,894 and taxes thereon of $2,106 for the purpose of including the same in her gross income under section 668. The result would be the same if the invasion power were not exercised and the accumulation distribution occurred as a result of the distribution of the corpus to D's issue upon the death of W.

Example 2. Trust A, a simple trust on the calendar year basis, received in 1972 extraordinary dividends or taxable stock dividends that the trustee in good faith allocated to corpus, but that are determined in 1974 to have been currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)–4. Trust A would qualify for treatment under subpart C for 1974, the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and is treated as another amount properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a) (2). Also, the distribution in 1974 qualifies as an accumulation distribution for the purposes of subpart D. For purposes only of such subpart D, trust A would be treated as subject to the provisions of such subpart C for 1972, the preceding taxable year in which the extraordinary or taxable stock dividends were received, and, in computing undistributed net income for 1972, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in 1974 was made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

[T.D. 7204, 37 FR 17141, Aug. 25, 1972]

§ 1.665(f)–1A Undistributed capital gain.

(a) *Domestic trusts.* (1) The term *undistributed capital gain* means (in the case of a trust other than a foreign trust created by a U.S. person), for any taxable year of the trust beginning after December 31, 1968, the gains in excess of losses for that year from the sale or exchange of capital assets of the trust less:

(i) The amount of such gains that are included in distributable net income under section 643(a)(3) and § 1.643(a)–3.

(ii) The amount of taxes imposed on the trust for such year attributable to such gains, as defined in § 1.665(d)–1A, and

(iii) In the case of a trust that does not use the alternative method for computing taxes on capital gains of the taxable year, the excess of deductions (other than deductions allowed under section 642(b) relating to personal exemption or section 642(c) relating to charitable contributions) over distributable net income for such year to the extent such excess deductions are properly allowable in determining taxable income for such year.

For purposes of computing the amount of capital gain under this paragraph, no deduction under section 1202, relating to deduction for excess of capital gains over capital losses, shall be taken into account. The application of this subparagraph may be illustrated by the following example:

Example. Under the terms of the trust, the trustee must distribute all income currently and has discretion to distribute capital gain to A or to allocate it to corpus. During the taxable year 1971 the trust recognized capital gain in the amount of $15,000, and capital losses of $5,000, and had interest income (after expenses) of $6,000. The trustee distributed $8,000 to A, consisting of $6,000 of interest and $2,000 of capital gain. The $2,000 of gain distributed to A is included in the computation of distributable net income under §1.643(a)–3. The balance of the capital gain is not included in distributable net income since it is allocated to corpus and not paid, credited, or required to be distributed to any beneficiary. The trust paid taxes of $671, all of which are attributable under §1.665(d)–1A to the undistributed capital gain. The amount of undistributed capital gain of the trust for 1971 is therefore $7,329, computed as follows:

Total capital gains	$15,000
Less: Capital losses	5,000
Gains in excess of losses	10,000
Less:	
Amount of capital gain included in distributable net income	2,000
Taxes imposed on the trust attributable to the undistributed capital gain (see §1.665(d)–1A)	671
	2,671
Undistributed capital gain	7,329

(2) For purposes of subparagraph (1) of this paragraph, the term *losses for that year* includes losses of the trusts from the sale or exchange of capital assets in preceding taxable years not included in the computation of distributable net income of any year, reduced by such losses taken into account in a subsequent preceding taxable year in computing undistributed capital gain but not reduced by such losses taken into account in determining the deduction under section 1211. See section 1212(b)(2) and the regulations thereunder. For example, assume that a trust had a net long-term capital loss in 1970 of $5,000. During the years 1971 through 1975, the trust had no capital gains or capital losses. In 1976, it has a long-term capital gain of $8,000, which it allocates to corpus and does not distribute to a beneficiary, but has no taxes attributable to such gain. The undistributed capital gain for 1976 is $8,000 − $5,000, or $3,000, even though all or a part of the $5,000 loss was claimed under section 1211 as a deduction in years 1970 through 1975.

(b) *Foreign trusts.* Distributable net income for a taxable year of a foreign trust created by a U.S. person includes capital gains in excess of capital losses for such year (see §1.643(a)–6(a)(3)). Thus, a foreign trust created by a U.S. person can never have any undistributed capital gain.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

§1.665(g)–1A Capital gain distribution.

For any taxable year of a trust, the term *capital gain distribution* means, to the extent of the undistributed capital gain of the trust, that portion of an accumulation distribution that exceeds the amount of such accumulation distribution deemed under section 666(a) to be undistributed net income of the trust for all preceding taxable years. See §1.665(b)–1A for the definition of ‘‘accumulation distribution’’. For any such taxable year the undistributed capital gain includes the total undistributed capital gain for all years of the trust beginning with the first taxable year beginning after December 31, 1968, in which income (as determined under section 643(b)) is accumulated, and ending before such taxable year. See §1.665(g)–2A for application of the separate share rule. The application of this section may be illustrated by the following example:

Example. A trust on the calendar year basis made the following accumulations. For purposes of this example, the undistributed net income is the same as income under applicable local law. No income was accumulated prior to 1970.

Year	Undistributed net income	Undistributed capital gain
1969	None	$10,000
1970	$1,000	3,000
1971	None	4,000

The trust has distributable net income in 1972 of $2,000 and recognizes capital gains of $4,500 that are allocable to corpus. On December 31, 1972, the trustee makes a distribution of $20,000 to the beneficiary. There is an accumulation distribution of $18,000 $20,000 distribution less $2,000 d.n.i.) that consists of undistributed net income of $1,000 (see §1.666(a)–1A) and a capital gain distribution of $7,000. The capital gain distribution is computed as follows:

Accumulation distribution	$18,000
Less: Undistributed net income	1,000
Balance	17,000
Capital gain distribution (undistributed capital gain of the trust for 1972 ($3,000 from 1970 and $4,000 from 1971))	7,000
Balance (corpus)	10,000

No undistributed capital gain is deemed distributed from 1969 because 1969 is a year prior to the first year in which income is accumulated (1970). The accumulation distribution is not deemed to consist of any part of the capital gains recognized in 1972.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

§ 1.665(g)–2A Application of separate share rule.

(a) *In general.* If the separate share rule of section 663(c) is applicable for any taxable year of a trust, subpart D is applied as if each share were a separate trust except as provided in paragraph (c) of this section and in § 1.668(a)–1A(c). Thus, the amounts of an ''accumulation distribution'', ''undistributed net income'', ''undistributed capital gain'', and ''capital gain distribution'' are computed separately for each share.

(b) *Allocation of taxes—undistributed net income.* The ''taxes imposed on the trust attributable to the undistributed net income'' are allocated as follows:

(1) There is first allocated to each separate share that portion of the ''taxes imposed on the trust attributable to the undistributed net income'' (as defined in § 1.665(d)–1A(b)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(i) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a) (5), (6), and (7); and

(ii) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the ''taxes imposed on the trust'' that bears the same relation to the total of such credits that the items of distributable net income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust.

(c) *Allocation of taxes—undistributed capital gain.* The ''taxes imposed on the trust attributable to undistributed capital gain'' are allocated as follows:

(1) There is first allocated to each separate share that portion of the ''taxes imposed on the trust attributable to undistributed capital gain'' (as defined in § 1.665(d)–1A(c)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the undistributed capital gain (prior to the deduction of taxes under section 665(c)(2)) of the separate share bears to the total such undistributed capital gain of the trust.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the ''taxes imposed on the trust'' that bears the same relation to the total of such credits that the capital gain allocable to the separate share with respect to which the credit is allowed bear to the total of such capital gain of the trust.

(d) *Termination of a separate share.* (1) If upon termination of a separate share, an amount is properly paid, credited, or required to be distributed by the trust under section 661(a)(2) to a beneficiary from such share, an accumulation distribution will be deemed to have been made to the extent of such amount. In determining the distributable net income of such share, only those items of income and deduction for the taxable year of the trust in which such share terminates, properly allocable to such share, shall be taken into consideration.

(2) No accumulation distribution will be deemed to have been made upon the termination of a separate share to the extent that the property constituting such share, or a portion thereof, continues to be held as a part of the same trust. The undistributed net income, undistributed capital gain, and the taxes imposed on the trust attributable to such items, if any, for all preceding taxable years (reduced by any amounts deemed distributed under sections 666(a) and 669(a) by reason of any accumulation distribution of undistributed net income or undistributed capital gain in prior years or the current taxable year), which were allocable to the terminating share, shall be treated as being applicable to the trust itself. However, no adjustment will be made to the amounts deemed distributed under sections 666 and 669 by reason of an accumulation distribution of undistributed net income or undistributed capital gain from the surviving share or shares made in years prior to the year in which the terminating share was added to such surviving share or shares.

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

Example. A trust was established under the will of X for the benefit of his wife and upon her death the property was to continue in the same trust for his two sons, Y and Z. The separate share rule is applicable to this trust. The trustee had discretion to pay or accumulate the income to the wife, and after her death was to pay each son's share to him after he attained the age of 25. When the wife died, Y was 23 and Z was 28.

(1) Upon the death of X's widow, there is no accumulation distribution. The entire trust is split into two equal shares, and therefore the undistributed net income and the undistributed capital gain of the trust are split into two shares.

(2) The distribution to Z of his share after his mother's death is an accumulation distribution of his separate share of one-half of the undistributed net income and undistributed capital gain.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS

§ 1.671–1 Grantors and others treated as substantial owners; scope.

(a) Subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, contains provisions taxing income of a trust to the grantor or another person under certain circumstances even though he is not treated as a beneficiary under subparts A through D (section 641 and following) of such part I. Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675).

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (section 677).

Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See §1.662 (a)–4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) The provisions of subpart E are not applicable with respect to a pooled income fund as defined in paragraph (5) of section 642(c) and the regulations thereunder, a charitable remainder annuity trust as defined in paragraph (1) of section 664(d) and the regulations thereunder, or a charitable remainder unitrust as defined in paragraph (2) of section 664(d) and the regulations thereunder.

(e) For the effective date of subpart E see section 683 and the regulations thereunder.

(f) For rules relating to the treatment of liabilities resulting on the sale or other disposition of encumbered trust property due to a renunciation of powers by the grantor or other owner, see §1.1001–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7148, 36 FR 20749, Oct. 29, 1971; T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§ 1.671–2 Applicable principles.

(a) Under section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in §1.671–3.

(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that ''income'' is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in §1.643(b)–1 is meant, the phrase ''ordinary income'' is used.

(c) An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country.

(d) Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under subpart E are subject to the provisions of subparts A through D (section 641 and following), of such part I.

(e)(1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. For purposes of this section, the term *property* includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also §1.672(f)–5(a).

(2)(i) A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

(ii) For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

(iii) For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust.

For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

(3) A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in §301.7701–4(c) of this chapter, liquidating trusts described in §301.7701–4(d) of this chapter, or environmental remediation trusts described in §301.7701–4(e) of this chapter.

(4) If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a

partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.

(5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(6) The following examples illustrate the rules of this paragraph (e). Unless otherwise indicated, all trusts are domestic trusts, and all other persons are United States persons. The examples are as follows:

Example 1. A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors of T.

Example 2. A makes an investment in a fixed investment trust, T, that is classified as a trust under § 301.7701–4(c)(1) of this chapter. A is a grantor of T. B subsequently acquires A's entire interest in T. Under paragraph (e)(3) of this section, B is a grantor of T with respect to such interest.

Example 3. A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of FT under sections 671 through 677 regardless of whether A retained any power over or interest in FT described in sections 673 through 677. Furthermore, A is not treated as an owner of any portion of FT under section 679. Both A and B are responsible parties for purposes of the requirements in section 6048.

Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 5. A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

Example 6. A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Example 7. A, B's brother, creates a trust, T, for B's benefit and transfers $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

Example 8. G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

Example 9. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

(7) The rules of this section are applicable to any transfer to a trust, or transfer of an interest in a trust, on or after August 10, 1999.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8831, 64 FR 43274, Aug. 10, 1999; T.D. 8890, 65 FR 41333, July 5, 2000]

§ 1.671–3 Attribution or inclusion of income, deductions, and credits against tax.

(a) When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example:

(1) If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D. See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example:

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674–678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause

that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676 (a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deductions, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For examples of computations under this paragraph, see paragraph (g) of § 1.677(a)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 742, Jan. 17, 1969]

§ 1.671–4 Method of reporting.

(a) *Portion of trust treated as owned by the grantor or another person.* Except as otherwise provided in paragraph (b) of this section, items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, is treated as owned by the grantor or another person are not reported by the trust on Form 1041, but are shown on a separate statement to be attached to that form. Section 301.7701–4(e)(2) of this chapter provides guidance on how these reporting rules apply to an environmental remediation trust.

(b) *A trust all of which is treated as owned by one or more grantors or other persons*—(1) *In general.* In the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in paragraph (b)(6) or (7) of this section, the trustee may, but is not required to, report by one of the methods described in this paragraph (b) rather than by the method described in paragraph (a) of this section. A trustee may not report, however, pursuant to paragraph (b)(2)(i)(A) of this section unless the grantor or other person treated as the owner of the trust provides to the trustee a complete Form W–9 or acceptable substitute Form W–9 signed under penalties of perjury. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W–9, depending upon the type of reportable payments made.

(2) *A trust all of which is treated as owned by one grantor or by one other person*—(i) *In general.* In the case of a trust all of which is treated as owned by one grantor or one other person, the trustee reporting under this paragraph (b) must either—

(A) Furnish the name and taxpayer identification number (TIN) of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(ii) of this section; or

(B) Furnish the name, TIN, and address of the trust to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(iii) of this section.

(ii) *Additional obligations of the trustee when name and TIN of the grantor or other person treated as the owner of the trust and the address of the trust are furnished to payors.* (A) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must furnish the grantor or other person treated as the owner of the trust with a statement that—

(*1*) Shows all items of income, deduction, and credit of the trust for the taxable year;

(*2*) Identifies the payor of each item of income;

(*3*) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(*4*) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(B) The trustee is not required to file any type of return with the Internal Revenue Service.

(iii) *Additional obligations of the trustee when name, TIN, and address of the trust are furnished to payors*—(A) *Obligation to file Forms 1099.* The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the grantor or other person treated as the owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) *Obligation to furnish statement.* (*1*) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must also furnish to the grantor or other person treated as the owner of the trust a statement that—

(*i*) Shows all items of income, deduction, and credit of the trust for the taxable year;

(*ii*) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(*iii*) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(*2*) By furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

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

Example 1. G, a United States citizen, creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 679. Under the applicable local law, capital gains must be added to corpus. Since G has a right to receive income, he is treated as an owner of a portion of the trust under section 677. The tax consequences of any items of capital gain of the trust are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. Because not all of the trust is treated as owned by the grantor or another person, the trustee may not report by the methods described in paragraph (b)(2) of this section.

Example 2. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. During the 1996 taxable year the trust has the following items of income and gross proceeds:

Interest	$2,500
Dividends	3,205
Proceeds from sale of B stock	2,000

(B) The trust has no items of deduction or credit.

(ii)(A) The payors of the interest paid to the trust are X ($2,000), Y ($300), and Z ($200). The payors of the dividends paid to the trust are A ($3,200), and D ($5). The payor of the gross proceeds paid to the trust is D, a brokerage firm, which held the B stock as the nominee for the trust. The B stock was purchased by T for $1,500 on January 3, 1996, and sold by T on November 29, 1996. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to X, Y, Z, A, and D. X, Y, and Z each furnish T with a Form 1099–INT showing the trust as the payee. A furnishes T with a Form 1099–DIV showing the trust as the payee. D does not furnish T with a Form 1099–DIV because D paid a dividend of less than $10 to T. D furnishes T with a Form 1099–B showing the trust as the payee.

(B) On or before February 28, 1997, T files a Form 1099–INT with the Internal Revenue Service on which T reports interest attributable to G, as the owner of the trust, of $2,500; a Form 1099–DIV on which T reports dividends attributable to G, as the owner of the trust, of $3,205; and a Form 1099–B on which T reports gross proceeds from the sale of B stock attributable to G, as the owner of the trust, of $2,000. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

Interest	$2,500
Dividends	3,205
Gain from sale of B stock	500

Information regarding sale of B stock:

Proceeds	$2,000
Basis	1,500
Date acquired	1/03/96
Date sold	11/29/96

(C) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(D) T has complied with T's obligations under this section.

(iii)(A) Same facts as paragraphs (i) and (ii) of this *Example 2,* except that G contributed the B stock to the trust on January 2, 1996. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

Interest	$2,500
Dividends	3,205

Information regarding sale of B stock:

Proceeds	$2,000
Date sold	11/29/96

(B) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(C) T has complied with T's obligations under this section.

Example 3. On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The only asset of the trust is an interest in C, a common trust fund under section 584(a). T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to C. C files a Form 1065 and a Schedule K–1 (Partner's Share of Income, Credits, Deductions, etc.) showing the name, TIN, and address of the trust with the Internal Revenue Service and furnishes a copy to T. Because the trust did not receive any amounts described in paragraph (b)(5) of this section, T does not file any type of return with the Internal Revenue Service. On or before April 15, 1997, T furnishes G with a statement that shows all items of income, deduction, and credit of the trust for the 1996 taxable year. In addition, T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person. T has complied with T's obligations under this section.

(3) *A trust all of which is treated as owned by two or more grantors or other persons*—(i) *In general.* In the case of a trust all of which is treated as owned by two or more grantors or other persons, the trustee must furnish the name, TIN, and address of the trust to all payors for the taxable year, and comply with the additional requirements described in paragraph (b)(3)(ii) of this section.

(ii) *Additional obligations of trustee*—(A) *Obligation to file Forms 1099.* The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the items of income paid to the trust by all payors during the taxable year attributable to the portion of the trust treated as owned by each grantor or other person, and showing the trust as the payor and each grantor or other person treated as an owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) *Obligation to furnish statement.* (*1*) The trustee must also furnish to each grantor or other person treated as an owner of the trust a statement that—

(*i*) Shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by the grantor or other person;

(*ii*) Provides the grantor or other person treated as an owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(*iii*) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(*2*) Except for the requirements pursuant to section 3406 and the regulations thereunder, by furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(4) *Persons treated as payors*—(i) *In general.* For purposes of this section, the term payor means any person who is required by any provision of the Internal Revenue Code and the regulations thereunder to make any type of information return (including Form 1099 or Schedule K–1) with respect to the trust for the taxable year, including persons who make payments to the trust or who collect (or otherwise act as middlemen with respect to) payments on behalf of the trust.

(ii) *Application to brokers and customers.* For purposes of this section, a broker, within the meaning of section 6045, is considered a payor. A customer, within the meaning of section 6045, is considered a payee.

(5) *Amounts required to be included on Forms 1099 filed by the trustee*—(i) *In general.* The amounts that must be included on any Forms 1099 required to be filed by the trustee pursuant to this section do not include any amounts that are reportable by the payor on an information return other than Form 1099. For example, in the case of a trust which owns an interest in a partnership, the trust's distributive share of the income and gain of the partnership is not includible on any Forms 1099 filed by the trustee pursuant to this section because the distributive share is reportable by the partnership on Schedule K–1.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(5):

Example. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The assets of the trust during the 1996 taxable year are shares of stock in X, an S corporation, a limited partnership interest in P, shares of stock in M, and shares of stock in N. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to X, P, M, and N. M furnishes T with a Form 1099–DIV showing the trust as the payee. N does not furnish T with a Form 1099–DIV because N paid a dividend of less than $10 to T. X and P furnish T with Schedule K–1 (Shareholder's Share of Income, Credits, Deductions, etc.) and Schedule K–1 (Partner's Share of Income, Credits, Deductions, etc.), respectively, showing the trust's name, TIN, and address.

(B) For the 1996 taxable year the trust has the following items of income and deduction:

Dividends paid by M	$12
Dividends paid by N	6
Administrative expense	$20

Items reported by X on Schedule K–1 attributable to trust's shares of stock in X:

Interest	$20
Dividends	35

Items reported by P on Schedule K–1 attributable to trust's limited partnership interest in P:

Ordinary income	$300

(ii)(A) On or before February 28, 1997, T files with the Internal Revenue Service a Form 1099–DIV on which T reports dividends attributable to G as the owner of the trust in the amount of $18. T does not file any other returns.

(*B*) T has complied with T's obligation under paragraph (b)(2)(iii)(A) of this section to file the appropriate Forms 1099.

(6) *Trusts that cannot report under this paragraph (b).* The following trusts cannot use the methods of reporting described in this paragraph (b)—

(i) A common trust fund as defined in section 584(a);

(ii) A trust that has its situs or any of its assets located outside the United States;

(iii) A trust that is a qualified subchapter S trust as defined in section 1361(d)(3);

(iv) A trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year;

(v) A trust all of which is treated as owned by one grantor or one other person who is not a United States person; or

(vi) A trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.

(7) *Grantors or other persons who are treated as owners of the trust and are exempt recipients for information reporting purposes*—(i) *Trust treated as owned by one grantor or one other person.* The trustee of a trust all of which is treated as owned by one grantor or one other person may not report pursuant to this paragraph (b) if the grantor or other person is an exempt recipient for information reporting purposes.

(ii) *Trust treated as owned by two or more grantors or other persons.* The trustee of a trust, all of which is treated as owned by two or more grantors or other persons, may not report pursuant to this paragraph (b) if one or more grantors or other persons treated as owners are exempt recipients for information reporting purposes unless—

(A) At least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes; and

(B) The trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.

(8) *Husband and wife who make a single return jointly.* A trust all of which is treated as owned by a husband and wife who make a single return jointly of income taxes for the taxable year under section 6013 is considered to be owned by one grantor for purposes of this paragraph (b).

(c) *Due date for Forms 1099 required to be filed by trustee.* The due date for any Forms 1099 required to be filed with the Internal Revenue Service by a trustee pursuant to this section is the due date otherwise in effect for filing Forms 1099.

(d) *Due date and other requirements with respect to statement required to be furnished by trustee*—(1) *In general.* The due date for the statement required to be furnished by a trustee to the grantor or other person treated as an owner of the trust pursuant to this section is the date specified by section 6034A(a). The trustee must maintain in its records a copy of the statement furnished to the grantor or other person treated as an owner of the trust for a period of three years from the due date for furnishing such statement specified in this paragraph (d).

(2) *Statement for the taxable year ending with the death of the grantor or other person treated as the owner of the trust.* If a trust ceases to be treated as owned by the grantor, or other person, by reason of the death of that grantor or other person (decedent), the due date for the statement required to be furnished for the taxable year ending with the death of the decedent shall be the date specified by section 6034A(a) as though the decedent had lived throughout the decedent's last taxable year. See paragraph (h) of this section for special reporting rules for a trust or portion of the trust that ceases to be treated as owned by the grantor or other person by reason of the death of the grantor or other person.

(e) *Backup withholding requirements*—(1) *Trustee reporting under paragraph (b)(2)(i)(A) of this section.* In order for the trustee to be able to report pursuant to paragraph (b)(2)(i)(A) of this section and to furnish to all payors the name and TIN of the grantor or other person treated as the owner of the trust, the grantor or other person must provide a complete Form W–9 to the trustee in the manner provided in paragraph (b)(1) of this section, and the trustee must give the name and TIN shown on that Form W–9 to all payors. In addition, if the Form W–9 indicates that the grantor or other person is subject to backup withholding, the trustee must notify all payors of reportable interest and dividend payments of the requirement to backup withhold. If the Form W–9 indicates that the grantor or other person is not subject to backup withholding, the trustee does not have to notify the payors that backup withholding is not required. The trustee should not give the Form W–9, or a copy thereof, to a payor because the Form W–9 contains the address of the grantor or other person and paragraph (b)(2)(i)(A) of this section requires the trustee to furnish the address of the trust to all payors and not the address of the grantor or other person. The trustee acts as the agent of the grantor or other person for purposes of furnishing to the payors the information required by this paragraph (e)(1). Thus, a payor may rely on the name and TIN provided to the payor by the trustee, and, if given, on the trustee's statement that the grantor is subject to backup withholding.

(2) *Other backup withholding requirements.* Whether a trustee is treated as a payor for purposes of backup withholding is determined pursuant to section 3406 and the regulations thereunder.

(f) *Penalties for failure to file a correct Form 1099 or furnish a correct statement.* A trustee who fails to file a correct Form 1099 or to furnish a correct statement to a grantor or other person treated as an owner of the trust as required by paragraph (b) of this section is subject to the penalties provided by sections 6721 and 6722 and the regulations thereunder.

(g) *Changing reporting methods*—(1) *Changing from reporting by filing Form 1041 to a method described in paragraph (b) of this section.* If the trustee has filed a Form 1041 for any taxable year ending before January 1, 1996 (and has not filed a final Form 1041 pursuant to § 1.671–4(b)(3) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995)), or files a Form 1041 for any taxable year thereafter, the trustee must file a final Form 1041 for the taxable year which ends after January 1, 1995, and which immediately precedes the first taxable year for which the trustee reports pursuant to paragraph (b) of this section, on the front of which form the trustee must write: ''Pursuant to § 1.671–4(g), this is the final Form 1041 for this grantor trust.''.

(2) *Changing from reporting by a method described in paragraph (b) of this section to the filing of a Form 1041.* The trustee of a trust who reported pursuant to paragraph (b) of this section for a taxable year may report pursuant to paragraph (a) of this section for subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(A) of this section, and therefore furnished the name and TIN of the grantor to all payors, the trustee must furnish the name, TIN, and address of

the trust to all payors for such subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(B) or (b)(3)(i) of this section, and therefore furnished the name and TIN of the trust to all payors, the trustee must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee so reports that it is the final return of the trust.

(3) *Changing between methods described in paragraph (b) of this section*—(i) *Changing from furnishing the TIN of the grantor to furnishing the TIN of the trust.* The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(A) of this section for a taxable year, and therefore furnished the name and TIN of the grantor to all payors, may report pursuant to paragraph (b)(2)(i)(B) of this section, and furnish the name and TIN of the trust to all payors, for subsequent taxable years.

(ii) *Changing from furnishing the TIN of the trust to furnishing the TIN of the grantor.* The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(B) of this section for a taxable year, and therefore furnished the name and TIN of the trust to all payors, may report pursuant to paragraph (b)(2)(i)(A) of this section, and furnish the name and TIN of the grantor to all payors, for subsequent taxable years. The trustee, however, must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee reports pursuant to paragraph (b)(2)(i)(B) of this section that it is the final return of the trust.

(4) *Example.* The following example illustrates the provisions of paragraph (g) of this section:

Example. (i) On January 3, 1994, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. On or before April 17, 1995, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1994 taxable year showing the items of income, deduction, and credit of the trust. On or before April 15, 1996, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1995 taxable year showing the items of income, deduction, and credit of the trust. On the Form 1041, T states that ''pursuant to § 1.671–4(g), this is the final Form 1041 for this grantor trust.'' T may report pursuant to paragraph (b) of this section for the 1996 taxable year.

(ii) T reports pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to all payors, for the 1996 and 1997 taxable years. T chooses to report pursuant to paragraph (a) of this section for the 1998 taxable year. On each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) which T files for the 1997 taxable year (or appropriately on magnetic media), T indicates that it is the trust's final return. On or before April 15, 1999, T files with the Internal Revenue Service a Form 1041 with an attached statement showing the items of income, deduction, and credit of the trust. On the Form 1041, T uses the same TIN which T used on the Forms 1041 and Forms 1099 it filed for previous taxable years. T has complied with T's obligations under paragraph (g)(2) of this section.

(h) *Reporting rules for a trust, or portion of a trust, that ceases to be treated as owned by a grantor or other person by reason of the death of the grantor or other person*—(1) *Definition of decedent.* For purposes of this paragraph (h), the *decedent* is the grantor or other person treated as the owner of the trust, or portion of the trust, under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code on the date of death of that person.

(2) *In general.* The provisions of this section apply to a trust, or portion of a trust, treated as owned by a decedent for the taxable year that ends with the decedent's death. Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under this section. A trust, all of which was treated as owned by the decedent, must obtain a new TIN upon the death of the decedent, if the trust will continue after the death of the decedent. See § 301.6109–1(a)(3)(i) of this chapter for rules regarding obtaining a TIN upon the death of the decedent.

(3) *Special rules*—(i) *Trusts reporting pursuant to paragraph (a) of this section for the taxable year ending with the decedent's death.* The due date for the filing of a return pursuant to paragraph (a) of this section for the taxable year ending

with the decedent's death shall be the due date provided for under § 1.6072–1(a)(2). The return filed under this paragraph for a trust all of which was treated as owned by the decedent must indicate that it is a final return.

(ii) *Trust reporting pursuant to paragraph (b)(2)(B) of this section for the taxable year of the decedent's death.* A trust that reports pursuant to paragraph (b)(2)(B) of this section for the taxable year ending with the decedent's death must indicate on each Form 1096 ''Annual Summary and Transmittal of the U.S. Information Returns'' that it files (or appropriately on magnetic media) for the taxable year ending with the death of the decedent that it is the final return of the trust.

(iii) *Trust reporting under paragraph (b)(3) of this section.* If a trust has been reporting under paragraph (b)(3) of this section, the trustee may not report under that paragraph if any portion of the trust has a short taxable year by reason of the death of the decedent and the portion treated as owned by the decedent does not terminate on the death of the decedent.

(i) *Effective date and transition rule*—(1) *Effective date.* The trustee of a trust any portion of which is treated as owned by one or more grantors or other persons must report pursuant to paragraphs (a), (b), (c), (d)(1), (e), (f), and (g) of this section for taxable years beginning on or after January 1, 1996.

(2) *Transition rule.* For taxable years beginning prior to January 1, 1996, the Internal Revenue Service will not challenge the manner of reporting of—

(i) A trustee of a trust all of which is treated as owned by one or more grantors or other persons who did not report in accordance with § 1.671–4(a) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) as in effect for taxable years beginning prior to January 1, 1996, but did report in a manner substantially similar to one of the reporting methods described in paragraph (b) of this section; or

(ii) A trustee of two or more trusts all of which are treated as owned by one or more grantors or other persons who filed a single Form 1041 for all of the trusts, rather than a separate Form 1041 for each trust, provided that the items of income, deduction, and credit of each trust were shown on a statement attached to the single Form 1041.

(3) *Effective date for paragraphs (d)(2) and (h) of this section.* Paragraphs (d)(2) and (h) of this section apply for taxable years ending on or after December 24, 2002.

(j) *Cross-reference.* For rules relating to employer identification numbers, and to the obligation of a payor of income or proceeds to the trust to furnish to the payee a statement to recipient, see § 301.6109–1(a)(2) of this chapter.

[T.D. 8633, 60 FR 66087, Dec. 21, 1995, as amended by T.D. 8668, 61 FR 19191, May 1, 1996; T.D. 9032, 67 FR 78381, Dec. 24, 2002]

§ 1.672(a)–1 Definition of adverse party.

(a) Under section 672(a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

(b) Ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part. Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

(c) The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under section 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

(d) The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder. For example, if the grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living, a power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor).

§ 1.672(b)–1 Nonadverse party.

A *nonadverse party* is any person who is not an adverse party.

§ 1.672(c)–1 Related or subordinate party.

Section 672(c) defines the term ''related or subordinate party''. The term, as used in sections 674(c) and 675(3), means any nonadverse party who is the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. For purposes of sections 674(c) and 675(3), these persons are presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on them unless shown not to be subservient by a preponderance of the evidence.

§ 1.672(d)–1 Power subject to condition precedent.

Section 672(d) provides that a person is considered to have a power described in subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

§ 1.672(f)–1 Foreign persons not treated as owners.

(a) *General rule*—(1) *Application of the general rule.* Section 672(f)(1) provides that subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code (the grantor trust rules) shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the United States or a domestic corporation. Accordingly, the grantor trust rules apply to the extent that any portion of the trust, upon application of the grantor trust rules without regard to section 672(f), is treated as owned by a United States citizen or resident or domestic corporation. The grantor trust rules do not apply to any portion of the trust to the extent that, upon application of the grantor trust rules without regard to section 672(f), that portion is treated as owned by a person other than a United States citizen or resident or domestic corporation, unless the person is described in §1.672(f)–2(a) (relating to certain foreign corporations treated as domestic corporations), or one of the exceptions set forth in §1.672(f)–3 is met, (relating to: trusts where the grantor can revest trust assets; trusts where the only amounts distributable are to the grantor or the grantor's spouse; and compensatory trusts). Section 672(f) applies to domestic and foreign trusts. Any portion of the trust that is not treated as owned by a grantor or another person is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(2) *Determination of portion based on application of the grantor trust rules.* The determination of the portion of a trust treated as owned by the grantor or other person is to be made based on the terms of the trust and the application of the grantor trust rules and section 671 and the regulations thereunder.

(b) *Example.* The following example illustrates the rules of this section:

Example. (i) A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his son, B, who is a United States citizen, with stock of Corporation X. A's brother, C, who also is a United States citizen, contributes stock of Corporation Y to the trust for the benefit of B. A has a reversionary interest within the meaning of section 673 in the X stock that would cause A to be treated as the owner of the X stock upon application of the grantor trust rules without regard to section 672(f). C has a reversionary interest within the meaning of section 673 in the Y stock that would cause C to be treated as the owner of the Y stock upon application of the grantor trust rules without regard to section 672(f). The trustee has discretion to accumulate or currently distribute income of DT to B.

(ii) Because A is a nonresident alien, application of the grantor trust rules without regard to section 672(f) would not result in the portion of the trust consisting of the X stock being treated as owned by a United States citizen or resident. None of the exceptions in §1.672(f)–3 applies because A cannot revest the X stock in A, amounts may be distributed during A's lifetime to B, who is neither a grantor nor a spouse of a grantor, and the trust is not a compensatory trust. Therefore, pursuant to paragraph (a)(1) of this section, A is not treated as an owner under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code, of the portion of the trust consisting of the X stock. Any distributions from such portion of the trust are subject to the rules of subparts A through D (641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(iii) Because C is a United States citizen, paragraph (a)(1) of this section does not prevent C from being treated under section 673 as the owner of the portion of the trust consisting of the Y stock.

(c) *Effective date.* The rules of this section are applicable to taxable years of a trust beginning after August 10, 1999.

[T.D. 8831, 64 FR 43275, Aug. 10, 1999]

§ 1.672(f)–2 Certain foreign corporations.

(a) *Application of general rule.* Subject to the provisions of paragraph (b) of this section, if the owner of any portion of a trust upon application of the grantor trust rules without regard to section 672(f) is a controlled foreign corporation (as defined in section 957), a passive foreign investment company (as defined in section 1297), or a foreign personal holding company (as defined in section 552), the corporation will be treated as a domestic corporation for purposes of applying the rules of §1.672(f)–1.

(b) *Gratuitous transfers to United States persons*—(1) *Transfer from trust to which corporation made a gratuitous transfer.* If a trust (or portion of a trust) to which a controlled foreign corporation, passive foreign investment company, or foreign personal holding company has made a gratuitous transfer (within the meaning of

§1.671–2(e)(2)), makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation for purposes of §1.672(f)–4(c), relating to gratuitous transfers from trusts (or portions of trusts) to which a partnership or foreign corporation has made a gratuitous transfer.

(2) *Transfer from trust over which corporation has a section 678 power.* If a trust (or portion of a trust) that a controlled foreign corporation, passive foreign investment company, or foreign personal holding company is treated as owning under section 678 makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation that had made a gratuitous transfer to the trust (or portion of a trust) and the rules of §1.672(f)–4(c) apply.

(c) *Special rules for passive foreign investment companies*—(1) *Application of section 1297.* For purposes of determining whether a foreign corporation is a passive foreign investment company as defined in section 1297, the grantor trust rules apply as if section 672(f) had not come into effect.

(2) *References to renumbered Internal Revenue Code section.* For taxable years of shareholders beginning on or before December 31, 1997, and taxable years of passive foreign investment companies ending with or within such taxable years of the shareholders, all references in this §1.672(f)–2 to section 1297 are deemed to be references to section 1296.

(d) *Examples.* The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust, and CFC is a controlled foreign corporation. The examples are as follows:

Example 1. Application of general rule. CFC creates and funds FT. CFC is the grantor of FT within the meaning of §1.671–2(e). CFC has a reversionary interest in FT within the meaning of section 673 that would cause CFC to be treated as the owner of FT upon application of the grantor trust rules without regard to section 672(f). Under paragraph (a) of this section, CFC is treated as a domestic corporation for purposes of applying the general rule of §1.672(f)–1. Thus, §1.672(f)–1 does not prevent CFC from being treated as the owner of FT under section 673.

Example 2. Distribution from trust to which CFC made gratuitous transfer. A, a nonresident alien, owns 40 percent of the stock of CFC. A's brother B, a resident alien, owns the other 60 percent of the stock of CFC. CFC makes a gratuitous transfer to FT. FT makes a gratuitous transfer to A's daughter, C, who is a resident alien. Under paragraph (b)(1) of this section, CFC will be treated as a foreign corporation for purposes of §1.672(f)–4(c). For further guidance, see §1.672(f)–4(g) *Example 2* through *Example 4.*

(e) *Effective date.* The rules of this section are generally applicable to taxable years of shareholders of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies beginning after August 10, 1999, and taxable years of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies ending with or within such taxable years of the shareholders.

[T.D. 8831, 64 FR 43276, Aug. 10, 1999, as amended by T.D. 8890, 65 FR 41334, July 5, 2000]

§ 1.672(f)–3 Exceptions to general rule.

(a) *Certain revocable trusts*—(1) *In general.* Subject to the provisions of paragraph (a)(2) of this section, the general rule of §1.672(f)–1 does not apply to any portion of a trust for a taxable year of the trust if the power to revest absolutely in the grantor title to such portion is exercisable solely by the grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) without the approval or consent of any other person. If the grantor can exercise such power only with the approval of a related or subordinate party who is subservient to the grantor, such power is treated as exercisable solely by the grantor. For the definition of *grantor,* see §1.671–2(e). For the definition of *related or subordinate party,* see §1.672(c)–1. For purposes of this paragraph (a), a related or subordinate party is subservient to the grantor unless the presumption in the last sentence of §1.672(c)–1 is rebutted by a preponderance of the evidence. A trust (or portion of a trust) that fails to qualify for the exception provided by this paragraph (a) for a particular taxable year of the trust will be subject to the general rule of §1.672(f)–1 for that taxable year and all subsequent taxable years of the trust.

(2) *183-day rule.* For purposes of paragraph (a)(1) of this section, the grantor is treated as having a power to revest for a taxable year of the trust only if the grantor has such power for a total of 183 or more days during the taxable year of the trust. If the first or last taxable year of the trust (including the year of the grantor's death) is less than 183 days, the grantor is treated as having a power to revest for purposes of paragraph (a)(1) of this section if the grantor has such power for each day of the first or last taxable year, as the case may be.

(3) *Grandfather rule for certain revocable trusts in existence on September 19, 1995.* Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of §1.672(f)–1 does not apply to any portion of a trust that was treated as owned by the grantor under section 676 on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) *Examples.* The following examples illustrate the rules of this paragraph (a):

Example 1. Grantor is owner. FP1, a foreign person, creates and funds a revocable trust, T, for the benefit of FP1's children, who are resident aliens. The trustee is a foreign bank, FB, that is owned and controlled by FP1 and FP2, who is FP1's brother. The power to revoke T and revest absolutely in FP1 title to the trust property is exercisable by FP1, but only with the approval or consent of FB. The trust instrument contains no standard that FB must apply in determining whether to approve or consent to the revocation of T. There are no facts that would suggest that FB is not subservient to FP1. Therefore, the exception in paragraph (a)(1) of this section is applicable.

Example 2. Death of grantor. Assume the same facts as in Example 1, except that FP1 dies. After FP1's death, FP2 has the power to withdraw the assets of T, but only with the approval of FB. There are no facts that would suggest that FB is not subservient to FP2. However, the exception in paragraph (a)(1) of this section is no longer applicable, because FP2 is not a grantor of T within the meaning of §1.671–2(e).

Example 3. Trustee is not related or subordinate party. Assume the same facts as in *Example 1,* except that neither FP1 nor any member of FP1's family has any substantial ownership interest or other connection with FB. FP1 can remove and replace FB at any time for any reason. Although FP1 can replace FB with a related or subordinate party if FB refuses to approve or consent to FP1's decision to revest the trust property in himself, FB is not a related or subordinate party. Therefore, the exception in paragraph (a)(1) of this section is not applicable.

Example 4. Unrelated trustee will consent to revocation. FP, a foreign person, creates and funds an irrevocable trust, T. The trustee is a foreign bank, FB, that is not a related or subordinate party within the meaning of §1.672(c)–1. FB has the discretion to distribute trust income or corpus to beneficiaries of T, including FP. Even if FB would in fact distribute all the trust property to FP if requested to do so by FP, the exception in paragraph (a)(1) of this section is not applicable, because FP does not have the power to revoke T.

(b) *Certain trusts that can distribute only to the grantor or the spouse of the grantor*—(1) *In general.* The general rule of §1.672(f)–1 does not apply to any trust (or portion of a trust) if at all times during the lifetime of the grantor the only amounts distributable (whether income or corpus) from such trust (or portion thereof) are amounts distributable to the grantor or the spouse of the grantor. For purposes of this paragraph (b), payments of amounts that are not gratuitous transfers (within the meaning of §1.671–2(e)(2)) are not amounts distributable. For the definition of *grantor,* see §1.671–2(e).

(2) *Amounts distributable in discharge of legal obligations*—(i) *In general.* A trust (or portion of a trust) does not fail to satisfy paragraph (b)(1) of this section solely because amounts are distributable from the trust (or portion thereof) in discharge of a legal obligation of the grantor or the spouse of the grantor. Subject to the provisions of paragraph (b)(2)(ii) of this section, an obligation is considered a legal obligation for purposes of this paragraph (b)(2)(i) if it is enforceable under the

local law of the jurisdiction in which the grantor (or the spouse of the grantor) resides.

(ii) *Related parties*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, an obligation to a person who is a related person for purposes of § 1.643(h)–1(e) (other than an individual who is legally separated from the grantor under a decree of divorce or of separate maintenance) is not a legal obligation for purposes of paragraph (b)(2)(i) of this section unless it was contracted bona fide and for adequate and full consideration in money or money's worth (see § 20.2043–1 of this chapter).

(B) *Exceptions*—(*1*) *Amounts distributable in support of certain individuals.* Paragraph (b)(2)(ii)(A) of this section does not apply with respect to amounts that are distributable from the trust (or portion thereof) to support an individual who—

(*i*) Would be treated as a dependent of the grantor or the spouse of the grantor under section 152(a)(1) through (9), without regard to the requirement that over half of the individual's support be received from the grantor or the spouse of the grantor; and

(*ii*) Is either permanently and totally disabled (within the meaning of section 22(e)(3)), or less than 19 years old.

(*2*) *Certain potential support obligations.* The fact that amounts might become distributable from a trust (or portion of a trust) in discharge of a potential obligation under local law to support an individual other than an individual described in paragraph (b)(2)(ii)(B)(*1*) of this section is disregarded if such potential obligation is not reasonably expected to arise under the facts and circumstances.

(*3*) *Reinsurance trusts.* [Reserved]

(3) *Grandfather rule for certain section 677 trusts in existence on September 19, 1995.* Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of § 1.672(f)–1 does not apply to any portion of a trust that was treated as owned by the grantor under section 677 (other than section 677(a)(3)) on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. Amounts distributable only to grantor or grantor's spouse. H and his wife, W, are both nonresident aliens. H is 70 years old, and W is 65. H and W have a 30-year-old child, C, a resident alien. There is no reasonable expectation that H or W will ever have an obligation under local law to support C or any other individual. H creates and funds an irrevocable trust, FT, using only his separate property. H is the grantor of FT within the meaning of § 1.671–2(e). Under the terms of FT, the only amounts distributable (whether income or corpus) from FT as long as either H or W is alive are amounts distributable to H or W. Upon the death of both H and W, C may receive distributions from FT. During H's lifetime, the exception in paragraph (b)(1) of this section is applicable.

Example 2. Effect of grantor's death. Assume the same facts as in *Example 1.* H predeceases W. Assume that W would be treated as owning FT under section 678 if the grantor trust rules were applied without regard to section 672(f). The exception in paragraph (b)(1) of this section is no longer applicable, because W is not a grantor of FT within the meaning of § 1.671–2(e).

Example 3. Amounts temporarily distributable to person other than grantor or grantor's spouse. Assume the same facts as in *Example 1,* except that C (age 30) is a law student at the time FT is created and the trust instrument provides that, as long as C is in law school, amounts may be distributed from FT to pay C's expenses. Thereafter, the only amounts distributable from FT as long as either H or W is alive will be amounts distributable to H or W. Even assuming there is an enforceable obligation under local law for H and W to support C while he is in school, distributions from FT in payment of C's expenses cannot qualify as distributions in discharge of a legal obligation under paragraph (b)(2) of this section, because C is neither permanently and totally disabled nor less than 19 years old. The exception in paragraph (b)(1) of this section is not applicable. After C graduates from law school, the exception in paragraph (b)(1) still will not be applicable, because amounts were distributable to C during the lifetime of H.

Example 4. Fixed investment trust. FC, a foreign corporation, invests in a domestic fixed investment trust, DT, that is classified as a trust under § 301.7701–4(c)(1) of this chapter. Under the terms of DT, the only amounts that are distributable from FC's portion of

DT are amounts distributable to FC. The exception in paragraph (b)(1) of this section is applicable to FC's portion of DT.

Example 5. Reinsurance trust. A domestic insurance company, DI, reinsures a portion of its business with an unrelated foreign insurance company, FI. To satisfy state regulatory requirements, FI places the premiums in an irrevocable domestic trust, DT. The trust funds are held by a United States bank and may be used only to pay claims arising out of the reinsurance policies, which are legally enforceable under the local law of the jurisdiction in which FI resides. On the termination of DT, any assets remaining will revert to FI. Because the only amounts that are distributable from DT are distributable either to FI or in discharge of FI's legal obligations within the meaning of paragraph (b)(2)(i) of this section, the exception in paragraph (b)(1) of this section is applicable.

Example 6. Trust that provides security for loan. FC, a foreign corporation, borrows money from B, an unrelated bank, to finance the purchase of an airplane. FC creates a foreign trust, FT, to hold the airplane as security for the loan from B. The only amounts that are distributable from FT while the loan is outstanding are amounts distributable to B in the event that FC defaults on its loan from B. When FC repays the loan, the trust assets will revert to FC. The loan is a legal obligation of FC within the meaning of paragraph (b)(2)(i) of this section, because it is enforceable under the local law of the country in which FC is incorporated. Paragraph (b)(2)(ii) of this section is not applicable, because B is not a related person for purposes of §1.643(h)–1(e). The exception in paragraph (b)(1) of this section is applicable.

(c) *Compensatory trusts*—(1) *In general.* The general rule of §1.672(f)–1 does not apply to any portion of—

(i) A nonexempt employees' trust described in section 402(b), including a trust created on behalf of a self-employed individual;

(ii) A trust, including a trust created on behalf of a self-employed individual, that would be a nonexempt employees' trust described in section 402(b) but for the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of §1.83–3(e); and

(iii) Any additional category of trust that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(2) *Exceptions.* The Commissioner may, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), designate categories of compensatory trusts to which the general rule of paragraph (c)(1) of this section does not apply.

(d) *Separate accounting for gratuitous transfers to grandfathered trusts after September 19, 1995.* If a trust that was treated as owned by the grantor under section 676 or 677 (other than section 677(a)(3)) on September 19, 1995, contains both amounts held in the trust on September 19, 1995, and amounts that were gratuitously transferred to the trust after September 19, 1995, paragraphs (a)(3) and (b)(3) of this section apply only if the amounts that were gratuitously transferred to the trust after September 19, 1995, are treated as a separate portion of the trust that is accounted for under the rules of §1.671–3(a)(2). If the amounts that were gratuitously transferred to the trust after September 19, 1995 are not so accounted for, the general rule of §1.672(f)–1 applies to the entire trust. If such amounts are so accounted for, and without regard to whether there is physical separation of the assets, the general rule of §1.672(f)–1 does not apply to the portion of the trust that is attributable to amounts that were held in the trust on September 19, 1995.

(e) *Effective date.* The rules of this section are generally applicable to taxable years of a trust beginning after August 10, 1999. The initial separate accounting required by paragraph (d) of this section must be prepared by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999.

[T.D. 8831, 64 FR 43276, Aug. 10, 1999, as amended by T.D. 8890, 65 FR 41334, July 5, 2000]

§ 1.672(f)–4 Recharacterization of purported gifts.

(a) *In general*—(1) *Purported gifts from partnerships.* Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States person (United States donee) directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from a partnership, the purported gift or bequest must be included in the United States donee's gross income as ordinary income.

(2) *Purported gifts from foreign corporations.* Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States donee directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from any foreign corporation, the purported gift or bequest must be included in the United States donee's gross income as if it were a distribution from the foreign corporation. If the foreign corporation is a passive foreign investment company (within the meaning of section 1297), the rules of section 1291 apply. For purposes of section 1012, the United States donee is not treated as having basis in the stock of the foreign corporation. However, for purposes of section 1223, the United States donee is treated as having a holding period in the stock of the foreign corporation on the date of the deemed distribution equal to the weighted average of the holding periods of the actual interest holders (other than any interest holders who treat the portion of the purported gift attributable to their interest in the foreign corporation in the manner described in paragraph (b)(1) of this section). For purposes of section 902, a United States donee that is a domestic corporation is not treated as owning any voting stock of the foreign corporation.

(b) *Exceptions*—(1) *Partner or shareholder treats transfer as distribution and gift.* Paragraph (a) of this section does not apply to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that either—

(i) A United States citizen or resident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for United States tax purposes as a distribution to such individual and a subsequent gift or bequest to the United States donee; or

(ii) A nonresident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for purposes of the tax laws of the nonresident alien individual's country of residence as a distribution to such individual and a subsequent gift or bequest to the United States donee, and the United States donee timely complied with the reporting requirements of section 6039F, if applicable.

(2) *All beneficial owners of domestic partnership are United States citizens or residents or domestic corporations.* Paragraph (a)(1) of this section does not apply to a purported gift or bequest from a domestic partnership if the United States donee can demonstrate to the satisfaction of the Commissioner that all beneficial owners (within the meaning of § 1.1441–1(c)(6)) of the partnership are United States citizens or residents or domestic corporations.

(3) *Contribution to capital of corporate United States donee.* Paragraph (a) of this section does not apply to the extent a United States donee that is a corporation can establish that the purported gift or bequest was treated for United States tax purposes as a contribution to the capital of the United States donee to which section 118 applies.

(4) *Charitable transfers.* Paragraph (a) of this section does not apply if either—

(i) The United States donee is described in section 170(c); or

(ii) The transferor has received a ruling or determination letter, which has been neither revoked nor modified, from the Internal Revenue Service recognizing its exempt status under section 501(c)(3), and the transferor made the transfer pursuant to an exempt purpose for which the transferor was created or organized. For purposes of the preceding sentence, a ruling or determination letter recognizing exemption may not be relied upon if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization.

(c) *Certain transfers from trusts to which a partnership or foreign corporation has made a gratuitous transfer—(1) Generally treated as distribution from partnership or foreign corporation.* Except as provided in paragraphs (c)(2) and (3) of this section, if a United States donee receives a gratuitous transfer (within the meaning of § 1.671–2(e)(2)) from a trust (or portion of a trust) to which a partnership or foreign corporation has made a gratuitous transfer, the United States donee must treat the transfer as a purported gift or bequest from the partnership or foreign corporation that is subject to the rules of paragraph (a) of this section (including the exceptions in paragraphs (b) and (f) of this section). This paragraph (c) applies without regard to who is treated as the grantor of the trust (or portion thereof) under § 1.671–2(e)(4).

(2) *Alternative rule.* Except as provided in paragraph (c)(3) of this section, if the United States tax computed under the rules of paragraphs (a) and (c)(1) of this section does not exceed the United States tax that would be due if the United States donee treated the transfer as a distribution from the trust (or portion thereof), paragraph (c)(1) of this section does not apply and the United States donee must treat the transfer as a distribution from the trust (or portion thereof) that is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. For purposes of paragraph (f) of this section, the transfer is treated as a purported gift or bequest from the partnership or foreign corporation that made the gratuitous transfer to the trust (or portion thereof).

(3) *Exception.* Neither paragraph (c)(1) of this section nor paragraph (c)(2) of this section applies to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that the transfer represents an amount that is, or has been, taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation. A transfer will be deemed to be made first out of amounts that have not been taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation, unless the United States donee can demonstrate to the satisfaction of the Commissioner that another ordering rule is more appropriate.

(d) *Definition of purported gift or bequest*—(1) *In general.* Subject to the provisions of paragraphs (d)(2) and (3) of this section, *a purported gift or bequest* for purposes of this section is any transfer of property by a partnership or foreign corporation other than a transfer for fair market value (within the meaning of § 1.671–2(e)(2)(ii)) to a person who is not a partner in the partnership or a shareholder of the foreign corporation (or to a person who is a partner in the partnership or a shareholder of a foreign corporation, if the amount transferred is inconsistent with the partner's interest in the partnership or the shareholder's interest in the corporation, as the case may be). For purposes of this section, the term *property* includes cash.

(2) *Transfers for less than fair market value*—(i) *Excess treated as purported gift or bequest.* Except as provided in paragraph (d)(2)(ii) of this section, if a transfer described in paragraph (d)(1) of this section is for less than fair market value, the excess of the fair market value of the property transferred over the value of the property received, services rendered, or the right to use property is treated as a purported gift or bequest.

(ii) *Exception for transfers to unrelated parties.* No portion of a transfer described in paragraph (d)(1) of this section will be treated as a purported gift or bequest for purposes of this section if the United States donee can demonstrate to the satisfaction of the Commissioner that the United States donee is not related to a partner or shareholder of the transferor within the meaning of § 1.643(h)–1(e) or does not have another relationship with a partner or shareholder of the transferor that establishes a reasonable basis for concluding that the transferor would make a gratuitous transfer to the United States donee.

(e) *Prohibition against affirmative use of recharacterization by taxpayers.* A taxpayer may not use the rules of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance.

(f) *Transfers not in excess of $10,000.* This section does not apply if, during the taxable year of the United States donee, the aggregate amount of purported gifts or bequests that is transferred to such United States donee directly or indirectly from all partnerships or foreign corporations that are related (within the meaning of section 643(i)) does not exceed $10,000. The aggregate amount must include gifts or bequests from persons that the United States donee knows or has reason to know are related to the partnership or foreign corporation (within the meaning of section 643(i)).

(g) *Examples.* The following examples illustrate the rules of this section. In each example, the amount that is transferred exceeds $10,000. The examples are as follows:

Example 1. Distribution from foreign corporation. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer of property directly to A's daughter, B, who is a resident alien. Under paragraph (a)(2) of this section, B generally must treat the transfer as a dividend from FC to the extent of FC's earnings and profits and as an amount received in excess of basis thereafter. If FC is a passive foreign investment company, B must treat the amount received as a distribution under section 1291. B will be treated as having the same holding period as A. However, under paragraph (b)(1)(ii) of this section, if B can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B, B may treat the transfer as a gift (provided B timely complied with the reporting requirements of section 6039F, if applicable).

Example 2. Distribution of corpus from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer to a foreign trust, FT, that has no other assets. FT immediately makes a gratuitous transfer in the same amount to A's daughter, B, who is a resident alien. Under paragraph (c)(1) of this section, B must treat the transfer as a transfer from FC that is subject to the rules of paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B must treat the transfer as a dividend from FC unless she can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B and that B timely complied with the reporting requirements of section 6039F, if applicable. The alternative rule in paragraph (c)(2) of this section would not apply as long as the United States tax computed under the rules of paragraph (a)(2) of this section is equal to or greater than the United States tax that would be due if the transfer were treated as a distribution from FT.

Example 3. Accumulation distribution from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien. FC is not a passive foreign investment company (as defined in section 1297). FC makes a gratuitous transfer of 100X to a foreign trust, FT, on January 1, 2001. FT has no other assets on January 1, 2001. Several years later, FT makes a gratuitous transfer of 1000X to A's daughter, B, who is a United States resident. Assume that the section 668 interest charge on accumulation distributions will apply if the transfer is treated as a distribution from FT. Under the alternative rule of paragraph (c)(2) of this section, B must treat the transfer as an accumulation distribution from FT, because the resulting United States tax liability is greater than the United States tax that would be due if the transfer were treated as a transfer from FC that is subject to the rules of paragraph (a) of this section.

Example 4. Transfer from trust that is treated as owned by United States citizen. Assume the same facts as in *Example 3,* except that A is a United States citizen. Assume that A treats and reports the transfer to FT as a constructive distribution to himself, followed by a gratuitous transfer to FT, and that A is properly treated as the grantor of FT within the meaning of §1.671–2(e). A is treated as the owner of FT under section 679 and, as required by section 671 and the regulations thereunder, A includes all of FT's items of income, deductions, and credit in computing his taxable income and credits. Neither paragraph (c)(1) nor paragraph (c)(2) of this section is applicable, because the exception in paragraph (c)(3) of this section applies.

Example 5. Transfer for less than fair market value. FC is a foreign corporation that is wholly owned by A, a nonresident alien. On January 15, 2001, FC transfers property directly to A's daughter, B, a resident alien, in exchange for 90X. The Commissioner later determines that the fair market value of the property at the time of the transfer was 100X. Under paragraph (d)(2)(i) of this section, 10X will be treated as a purported gift to B on January 15, 2001.

(h) *Effective date.* The rules of this section are generally applicable to any transfer after August 10, 1999, by a partnership or foreign corporation, or by a trust to which a partnership or foreign corporation makes a gratuitous transfer after August 10, 1999.

[T.D. 8831, 64 FR 43278, Aug. 10, 1999, as amended by T.D. 8890, 65 FR 41334, July 5, 2000]

1.672(f)–5 Special rules.

(a) *Transfers by certain beneficiaries to foreign grantor*—(1) *In general.* If, but for section 672(f)(5), a foreign person would be treated as the owner of any portion of a trust, any United States beneficiary of the trust is treated as the grantor of a portion of the trust to the extent the United States beneficiary directly or indirectly made transfers of property to such foreign person (without regard to whether the United States beneficiary was a United States beneficiary at the time of any transfer) in excess of transfers to the United States beneficiary from the foreign person. The rule of this paragraph (a) does not apply to the extent the United States beneficiary can demonstrate to the satisfaction of the Commissioner that the transfer by the United States beneficiary to the foreign person was wholly unrelated to any transaction involving the trust. For purposes of this paragraph (a), the term property includes cash, and a transfer of property does not include a transfer that is not a gratuitous transfer (within the meaning of §1.671–2(e)(2)). In addition, a gift is not taken into account to the extent such gift would not be characterized as a taxable gift under section 2503(b). For a definition of United States beneficiary, see section 679.

(2) *Examples.* The following examples illustrate the rules of this section:

Example 1. A, a nonresident alien, contributes property to FC, a foreign corporation that is wholly owned by A. FC creates a foreign trust, FT, for the benefit of A and A's children. FT is revocable by FC without the approval or consent of any other person. FC funds FT with the property received from A. A and A's family move to the United States. Under paragraph (a)(1) of this section, A is treated as a grantor of FT. (A may also be treated as an owner of FT under section 679(a)(4).)

Example 2. B, a United States citizen, makes a gratuitous transfer of $1 million to B's uncle, C, a nonresident alien. C creates a foreign trust, FT, for the benefit of B and B's children. FT is revocable by C without the approval or consent of any other person. C funds FT with the property received from B. Under paragraph (a)(1) of this section, B is treated as a grantor of FT. (B also would be treated as an owner of FT as a result of section 679.)

(b) *Entity characterization.* Entities generally are characterized under United States tax principles for purposes of §§1.672(f)–1 through 1.672(f)–5. See §§301.7701–1 through 301.7701–4 of this chapter. However, solely for purposes of §1.672(f)–4, a transferor that is a wholly owned business entity is treated as a corporation, separate from its single owner.

(c) *Effective date.* The rules in paragraph (a) of this section are applicable to transfers to trusts on or after August 10, 1999. The rules in paragraph (b) of this section are applicable August 10, 1999.

[T.D. 8831, 64 FR 43280, Aug. 10, 1999, as amended by T.D. 8890, 65 FR 41334, July 5, 2000]

§1.673(a)–1 Reversionary interests; income payable to beneficiaries other than certain charitable organizations; general rule.

(a) Under section 673(a), a grantor, in general, is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or income if, as of the inception of that portion of the trust, the grantor's interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of transfer of that portion of the trust. However, the following types of reversionary interests are excepted from the general rule of the preceding sentence:

(1) A reversionary interest after the death of the income beneficiary of a trust (see paragraph (b) of this section); and

(2) Except in the case of transfers in trust made after April 22, 1969, a reversionary interest in a charitable trust meeting the requirements of section 673(b) (see §1.673(b)–1). Even though the duration of the trust may be such that the grantor is not treated as its owner under section 673, and therefore is not taxed on the ordinary income, he may nevertheless be treated as an owner

under section 677(a)(2) if he has a reversionary interest in the corpus. In the latter case, items of income, deduction, and credit allocable to corpus, such as capital gains and losses, will be included in the portion he owns. See §1.671–3 and the regulations under section 677. See §1.673(d)–1 with respect to a postponement of the date specified for reacquisition of a reversionary interest.

(b) Section 673(c) provides that a grantor is not treated as the owner of any portion of a trust by reason of section 673 if his reversionary interest in the portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the portion is regardless of the life expectancies of the income beneficiaries. If his reversionary interest is to take effect on or after the death of an income beneficiary or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner if the specific term of years is less than 10 years (but not if the term is 10 years or longer).

(c) Where the grantor's reversionary interest in a portion of a trust is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years or the death of the income beneficiary, the grantor is treated as the owner of the portion if the event may reasonably be expected to occur within 10 years from the date of transfer of that portion, but he is not treated as the owner under section 673 if the event may not reasonably be expected to occur within 10 years from that date. For example, if the reversionary interest in any portion of a trust is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) the grantor is treated under section 673 as the owner of the portion if the life expectancy of the grantor (or other person) is less than 10 years on the date of transfer of the portion, but not if the life expectancy is 10 years or longer. If the reversionary interest in any portion is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner of the portion if on the date of transfer of the portion either the life expectancy of the grantor (or other person) or the specific term is less than 10 years; however, if both the life expectancy and the specific term are 10 years or longer the grantor is not treated as the owner of the portion under section 673. Similarly, if the grantor has a reversionary interest in any portion which will take effect at the death of the income beneficiary or the grantor, whichever is earlier, the grantor is not treated as an owner of the portion unless his life expectancy is less than 10 years.

(d) It is immaterial that a reversionary interest in corpus or income is subject to a contingency if the reversionary interest may, taking the contingency into consideration, reasonably be expected to take effect in possession or enjoyment within 10 years. For example, the grantor is taxable where the trust income is to be paid to the grantor's son for 3 years, and the corpus is then to be returned to the grantor if he survives that period, or to be paid to the grantor's son if he is already decreased.

(e) See section 671 and §§1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23742, June 2, 1975]

§1.673(b)–1 Income payable to charitable beneficiaries before amendment by Tax Reform Act of 1969).

(a) Pursuant to section 673(b) a grantor is not treated as an owner of any portion of a trust under section 673, even though he has a reversionary interest which will take effect within 10 years, to the extent that, under the terms of the trust, the income of the portion is irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary of the type described in section 170(b)(1)(A).

(b) Income must be irrevocably payable to a designated beneficiary for at least 2 years commencing with the date of the transfer before the benefit of section 673(b) will apply. Thus, section 673(b) will not apply if income of a trust is irrevocably payable to University A for 1 year and then to University B for the next year; or if income of a trust may be allocated among two or more charitable beneficiaries in the discretion of the trustee or any other person. On the other hand, section 673(b) will apply if half the income of a trust is irrevocably payable to University A and the other half is irrevocably payable to University B for two years.

(c) Section 673(b) applies to the period of 2 years or longer during which income is paid to a designated beneficiary of the type described in section 170(b)(1)(A) (i), (ii), or (iii), even though the trust term is to extend beyond that period. However, the other provisions of section 673 apply to the part of the trust term, if any, that extends beyond that period. This paragraph may be illustrated by the following example:

Example. G transfers property in trust with the ordinary income payable to University C (which qualifies under section 170(b)(1)(A)(ii)) for 3 years, and then to his son, B, for 5 years. At the expiration of the term the trust reverts to G. G is not taxed under section 673 of the trust income payable to University C for the first 3 years because of the application of section 673(b). However, he is taxed on income for the next 5 years because he has a reversionary interest which will take effect within 10 years commencing with the date of the transfer. On the other hand, if the income were payable to University C for 3 years and then to R for 7 years so that the trust corpus would not be returned to G within 10 years, G would not be taxable under section 673 on income payable to University C and to B during any part of the term.

(d) This section does not apply to transfers in trust made after April 22, 1969.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by TD, 6605, 27 FR 8097, Aug. 15, 1962; T.D. 7357, 40 FR 23743, June 2, 1975]

§ 1.673(c)–1 Reversionary interest after income beneficiary's death.

The subject matter of section 673(c) is covered in paragraph (b) of § 1.673(a)–1.

§ 1.673(d)–1 Postponement of date specified for reacquisition.

Any postponement of the date specified for the reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, the grantor will not be treated as the owner of any portion of a trust for any taxable year by reason of the foregoing sentence if he would not be so treated in the absence of any postponement. The rules contained in this section may be illustrated by the following example:

Example. G places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to G or his estate. After the expiration of 9 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under section 673 for the first 3 years of the new term because he would not be so treated if the term of the trust had not been extended. G is treated as the owner of the trust, however, for the remaining 2 years.

§ 1.674(a)–1 Power to control beneficial enjoyment; scope of section 674.

(a) Under section 674, the grantor is treated as the owner of a portion of trust if the grantor or a nonadverse party has a power, beyond specified limits, to dispose of the beneficial enjoyment of the income or corpus, whether the power is a fiduciary power, a power of appointment, or any other power. Section 674(a) states in general terms that the grantor is treated as the owner in every case in which he or a nonadverse party can affect the beneficial enjoyment of a portion of a trust, the limitations being set forth as exceptions in subsections (b), (c), and (d) of section 674. These exceptions are discussed in detail in §§ 1.674(b)–1 through 1.674(d)—1. Certain limitations applicable to section 674 (b), (c), and (d) are set forth in § 1.674(d)–2. Section 674(b) describes powers which are excepted regardless of who holds them. Section 674(c) describes additional powers of trustees which are excepted if at least half the trustees are independent, and if the grantor is not a trustee. Section 674(d) describes a further power which is excepted if it is held by trustees other than the grantor or his spouse (if living with the grantor).

(b) In general terms the grantor is treated as the owner of a portion of a trust if he or a nonadverse party or both has a power to dispose of the beneficial enjoyment of the corpus or income unless the power is one of the following:

(1) *Miscellaneous powers over either ordinary income or corpus.* (i) A power that can only affect the beneficial enjoyment of income (including capital gains) received after a period of time such that the grantor would not be treated as an owner under section 673 if the power were a reversionary interest (section 674(b)(2));

(ii) A testamentary power held by anyone (other than a testamentary power held by the grantor over accumulated income) (section 674(b)(3));

(iii) A power to choose between charitable beneficiaries or to affect the manner of their enjoyment of a beneficial interest (section 674(b)(4));

(iv) A power to allocate receipts and disbursements between income and corpus (section 674(b)(8)).

(2) *Powers of distribution primarily affecting only one beneficiary.* (i) A power to distribute corpus to or for a current income beneficiary, if the distribution must be charged against the share of corpus from which the beneficiary may receive income (section 674(b)(5)(B));

(ii) A power to distribute income to or for a current income beneficiary or to accumulate it either *(a)* if accumulated income must either be payable to the beneficiary from whom it was withheld or as described in paragraph (b)(6) of § 1.674(b)–1 (section 674(b) (6)); *(b)* if the power is to apply income to the support of a dependent of the grantor, and the income is not so applied (section 674(b)(1)); or *(c)* if the beneficiary is under 21 or under a legal disability and accumulated income is added to corpus (section 674(b)(7)).

(3) *Powers of distribution affecting more than one beneficiary.* A power to distribute corpus or income to or among one or more beneficiaries or to accumulate income, either (i) if the power is held by a trustee or trustees other than the grantor, at least half of whom are independent (section 674(c)), or (ii) if the power is limited by a reasonably definite standard in the trust instrument, and in the case of a power over income, if in addition the power is held by a trustee or trustees other than the grantor and the grantor's spouse living with the grantor (section 674(b)(5)(A) and (d)). (These powers include both powers to ''sprinkle'' income or corpus among current beneficiaries, and powers to shift income or corpus between current beneficiaries and remaindermen; however, certain of the powers described under subparagraph (2) of this paragraph can have the latter effect incidentally.)

(c) See section 671 and §§ 1.671–2 and 1.671–3 for rules for the treatment of income, deductions, and credits when a person is treated as the owner of all or only a portion of a trust.

§ 1.674(b)–1 Excepted powers exercisable by any person.

(a) Paragraph (b) (1) through (8) of this section sets forth a number of powers which may be exercisable by any person without causing the grantor to be treated as an owner of a trust under section 674(a). Further, with the exception of powers described in paragraph (b)(1) of this section, it is immaterial whether these powers are held in the capacity of trustee. It makes no difference under section 674(b) that the person holding the power is the grantor, or a related or subordinate party (with the qualifications noted in paragraph (b) (1) and (3) of this section).

(b) The exceptions referred to in paragraph (a) of this section are as follows (see, however, the limitations set forth in § 1.674(d)–2):

(1) *Powers to apply income to support of a dependent.* Section 674(b)(1) provides, in effect, that regardless of the general rule of section 674(a), the income of a trust will not be considered as taxable to the grantor merely because in the discretion of any person (other than a grantor who is not acting as a trustee or cotrustee) it may be used for the support of a beneficiary whom the grantor is legally obligated to support, except to the extent that it is in fact

used for that purpose. See section 677(b) and the regulations thereunder.

(2) *Powers affecting beneficial enjoyment only after a period.* Section 674(b)(2) provides an exception to section 674(a) if the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. For example, if a trust created on January 1, 1955, provides for the payment of income to the grantor's son, and the grantor reserves the power to substitute other beneficiaries of income or corpus in lieu of his son on or after January 1, 1965, the grantor is not treated under section 674 as the owner of the trust with respect to ordinary income received before January 1, 1965. But the grantor will be treated as an owner on and after that date unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673(d)–1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(3) *Testamentary powers.* Under paragraph (3) of section 674(b) a power in any person to control beneficial enjoyment exercisable only by will does not cause a grantor to be treated as an owner under section 674(a). However, this exception does not apply to income accumulated for testamentary disposition by the grantor or to income which may be accumulated for such distribution in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. For example, if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. (See § 1.671–3.)

(4) *Powers to determine beneficial enjoyment of charitable beneficiaries.* Under paragraph (4) of section 674(b) a power in any person to determine the beneficial enjoyment of corpus or income which is irrevocably payable (currently or in the future) for purposes specified in section 170(c) (relating to definition of charitable contributions) will not cause the grantor to be treated as an owner under section 674(a). For example, if a grantor creates a trust, the income of which is irrevocably payable solely to educational or other organizations that qualify under section 170(c), he is not treated as an owner under section 674 although he retains the power to allocate the income among such organizations.

(5) *Powers to distribute corpus.* Paragraph (5) of section 674(b) provides an exception to section 674(a) for powers to distribute corpus, subject to certain limitations, as follows:

(i) If the power is limited by a reasonably definite standard which is set forth in the trust instrument, it may extend to corpus distributions to any beneficiary or beneficiaries or class of beneficiaries (whether income beneficiaries or remaindermen) without causing the grantor to be treated as an owner under section 674. See section 674(b)(5)(A). It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

(ii) If the power is not limited by a reasonably definite standard set forth in the trust instrument, the exception applies only if distributions of corpus may be made solely in favor of current income beneficiaries, and any corpus distribution to the current income beneficiary must be chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust (whether or not physically segregated). See section 674(b)(5)(B).

(iii) This subparagraph may be illustrated by the following examples:

Example 1. A trust instrument provides for payment of the income to the grantor's two brothers for life, and for payment of the corpus to the grantor's nephews in equal shares. The grantor reserves the power to distribute corpus to pay medical expenses that may be incurred by his brothers or nephews. The grantor is not treated as an owner by reason of this power because section 674(b)(5)(A) excepts a power, exercisable by any person, to invade corpus for any beneficiary, including a remainderman, if the power is limited by a reasonably definite standard which is set forth in the trust instrument. However, if the power were also exercisable in favor of a person (for example, a sister) who was not otherwise a beneficiary of the trust, section 674(b)(5)(A) would not be applicable.

Example 2. The facts are the same as in example 1 except that the grantor reserves the power to distribute any part of the corpus to his brothers or to his nephews for their happiness. The grantor is treated as the owner of the trust. Paragraph (5)(A) of section 674(b) is inapplicable because the power is not limited by a reasonably definite standard. Paragraph (5)(B) is inapplicable because the power to distribute corpus permits a distribution of corpus to persons other than current income beneficiaries.

Example 3. A trust instrument provides for payment of the income to the grantor's two adult sons in equal shares for 10 years, after which the corpus is to be distributed to his grandchildren in equal shares. The grantor reserves the power to pay over to each son up to one-half of the corpus during the 10-year period, but any such payment shall proportionately reduce subsequent income and corpus payments made to the son receiving the corpus. Thus, if one-half of the corpus is paid to one son, all the income from the remaining half is thereafter payable to the other son. The grantor is not treated as an owner under section 674(a) by reason of this power because it qualifies under the exception of section 674(b)(5)(B).

(6) *Powers to withhold income temporarily.* (i) Section 674(b)(6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either:

(a) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674(b)(6)(A));

(b) To the beneficiary from whom it was withheld, or if he does not survive a date of distribution which could reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or of the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(A) and the flush material following); or

(c) On termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default

of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(B) and the flush material following).

(In the application of *(a)* of this subdivision, if the accumulated income of a trust is ultimately payable to the estate of the current income beneficiary or is ultimately payable to his appointees or takers in default of appointment, under a power of the type described in *(a)* of this subdivision, it need not be payable to the beneficiary from whom it was withheld under any circumstances. Furthermore, if a trust otherwise qualifies for the exception in *(a)* of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in *(a)* of this subdivision.) In general, the exception in section 674(b)(6) is not applicable if the power is in substance one to shift ordinary income from one beneficiary to another. Thus, a power will not qualify for this exception if ordinary income may be distributed to beneficiary A, or may be added to corpus which is ultimately payable to beneficiary B, a remainderman who is not a current income beneficiary. However, section 674(b)(6)(B), and *(c)* of this subdivision, permit a limited power to shift ordinary income among current income beneficiaries, as illustrated in example 1 of this subparagraph.

(ii) The application of section 674(b)(6) may be illustrated by the following examples:

Example 1. A trust instrument provides that the income shall be paid in equal shares to the grantor's two adult daughters but the grantor reserves the power to withhold from either beneficiary any part of that beneficiary's share of income and to add it to the corpus of the trust until the younger daughter reaches the age of 30 years. When the younger daughter reaches the age of 30, the trust is to terminate and the corpus is to be divided equally between the two daughters or their estates. Although exercise of this power may permit the shifting of accumulated income from one beneficiary to the other (since the corpus with the accumulations is to be divided equally) the power is excepted under section 674(b)(6)(B) and subdivision (i)*(c)* of this subparagraph.

Example 2. The facts are the same as in example 1, except that the grantor of the trust reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. The combined powers are not excepted by section 674(b)(6)(B) since income accumulated pursuant to the first power is neither required to be payable only in conjunction with a corpus distribution nor required to be payable in shares specified in the trust instrument. See, however, section 674(c) and §1.674(c)–1 for the effect of such a power if it is exercisable only by independent trustees.

Example 3. A trust provides for payment of income to the grantor's adult son with the grantor retaining the power to accumulate the income until the grantor's death, when all accumulations are to be paid to the son. If the son predeceases the grantor, all accumulations are, at the death of the grantor, to be paid to his daughter, or if she is not living, to alternate takers (which do not include the grantor's estate) in specified shares. The power is excepted under section 674(b)(6)(A) since the date of distribution (the date of the grantor's death) may, in the usual case, reasonably be expected to occur during the beneficiary's (the son's) lifetime. It is not necessary that the accumulations be payable to the son's estate or his appointees if he should predecease the grantor for this exception to apply.

(7) *Power to withhold income during disability.* Section 674(b)(7) provides an exception for a power which, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he is under 21. Specifically, there is excepted a power, exercisable only during the existence of a legal disability of any current income beneficiary or the period during which any income beneficiary is under the age of 21 years, to distribute or apply ordinary income to or for that beneficiary or to accumulate the income and add it to corpus. To qualify under this exception it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, his estate, or his appointees; that is, the accumulated income may be added to corpus and ultimately distributed to others. For example, the grantor is not treated as an owner under section 674 if the income of a trust is payable to his son for life, remainder to his grandchildren, although he reserves the

power to accumulate income and add it to corpus while his son is under 21.

(8) *Powers to allocate between corpus and income.* Paragraph (8) of section 674(b) provides that a power to allocate receipts and disbursements between corpus and income, even though expressed in broad language, will not cause the grantor to be treated as an owner under the general rule of section 674(a).

§ 1.674(c)–1 Excepted powers exercisable only by independent trustees.

Section 674(c) provides an exception to the general rule of section 674(a) for certain powers that are exercisable by independent trustees. This exception is in addition to those provided for under section 674(b) which may be held by any person including an independent trustee. The powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. (See section 672(c) for definitions of these terms.) An example of the application of section 674(c) is a trust whose income is payable to the grantor's three adult sons with power in an independent trustee to allocate without restriction the amounts of income to be paid to each son each year. Such a power does not cause the grantor to be treated as the owner of the trust. See however, the limitations set forth in § 1.674(d)–2.

§ 1.674(d)–1 Excepted powers exercisable by any trustee other than grantor or spouse.

Section 674(d) provides an additional exception to the general rule of section 674(a) for a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, whether or not the conditions of section 674(b) (6) or (7) are satisfied, if the power is solely exercisable (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor or spouse living with the grantor, and if the power is limited by a reasonably definite external standard set forth in the trust instrument (see paragraph (b)(5) of § 1.674(b)–1 with respect to what constitutes a reasonably definite standard). See, however, the limitations set forth in § 1.674(d)–2.

§ 1.674(d)–2 Limitations on exceptions in section 674 (b), (c), and (d).

(a) *Power to remove trustee.* A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674 (c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674 (c) or (d). On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674 (c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c).

(b) *Power to add beneficiaries.* The exceptions described in section 674 (b) (5), (6), and (7), (c), and (d), are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers).

§ 1.675–1 Administrative powers.

(a) *General rule.* Section 675 provides in effect that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. If a grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under section 675, he will be treated as the owner of the portion from its inception. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) *Prohibited controls.* The circumstances which cause administrative controls to be considered exercisable primarily for the benefit of the grantor are specifically described in paragraphs (1) through (4) of section 675 as follows:

(1) The existence of a power, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, which enables the grantor or any other person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income of the trust for less than adequate consideration in money or money's worth. Whether the existence of the power itself will constitute the holder an adverse party will depend on the particular circumstances.

(2) The existence of a power exercisable by the grantor or a nonadverse party, or both, which enables the grantor to borrow the corpus or income of the trust, directly or indirectly, without adequate interest or adequate security. However, this paragraph does not apply where a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security. A general lending power in the grantor, acting alone as trustee, under which he has power to determine interest rates and the adequacy of security is not in itself an indication that the grantor has power to borrow the corpus or income without adequate interest or security.

(3) The circumstance that the grantor has directly or indirectly borrowed the corpus or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence does not apply to a loan which provides for adequate interest and adequate security, if it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. See section 672(c) for definition of ''a related or subordinate party''.

(4) The existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term *powers of administration* means one or more of the following powers:

(i) A power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

(ii) A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(iii) A power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

(c) *Authority of trustee.* The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

§ 1.676(a)–1 Power to revest title to portion of trust property in grantor; general rule.

If a power to revest in the grantor title to any portion of a trust is exercisable by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party, the grantor is treated as the owner of that portion, except as provided in section 676(b) (relating to powers affecting beneficial enjoyment of income only after the expiration of certain periods of time). If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a nonadverse party, or both, the grantor is treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.676(b)–1 Powers exercisable only after a period of time.

Section 676(b) provides an exception to the general rule of section 676(a) when the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after the expiration of a period of time which is such that a grantor would not be treated as the owner of that portion, except as power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. Thus, for example, a grantor is excepted from the general rule of section 676(a) with respect to ordinary income if exercise of a power to revest corpus in him cannot affect the beneficial enjoyment of the income received within 10 years after the date of transfer of that portion of the trust. It is immaterial for this purpose that the power is vested at the time of the transfer. However, the grantor is subject to the general rule of section 676(a) after the expiration of the period unless the power is relinquished. Thus, in the above example, the grantor may be treated as the owner and be taxed on all income in the eleventh and succeeding years if exercise of the power can affect beneficial enjoyment of income received in those years. If the beginning of the period during which the grantor may revest is postponed, the rules set forth in § 1.673(d)–1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.

§ 1.677(a)–1 Income for benefit of grantor; general rule.

(a)(1) *Scope.* Section 677 deals with the treatment of the grantor of a trust as the owner of a portion of the trust because he has retained an interest in the income from that portion. For convenience, ''grantor'' and ''spouse'' are generally referred to in the masculine and feminine genders, respectively, but if the grantor is a woman the reference to ''grantor'' is to her and the reference to ''spouse'' is to her husband. Section 677 also deals with the treatment of the grantor of a trust as the owner of a portion of the trust because the income from property transferred in trust after October 9, 1969, is, or may be, distributed to his spouse or applied to the payment of premiums on policies of insurance on the life of his spouse. However, section 677 does not apply when the income of a trust is taxable to a grantor's spouse under section 71 (relating to alimony and separate maintenance payments) or section 682 (relating to income of an estate or trust in case of divorce, etc.). See section 671–1(b).

(2) *Cross references.* See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or a portion of a trust.

(b) *Income for benefit of grantor or his spouse; general rule*—(1) *Property transferred in trust prior to October 10, 1969.* With respect to property transferred in trust prior to October 10, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section 674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor or a nonadverse party, or both (without the approval or consent of any adverse party) may be:

(i) Distributed to the grantor;

(ii) Held or accumulated for future distribution to the grantor; or

(iii) Applied to the payment of premiums on policies of insurance on the life of the grantor, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

(2) *Property transferred in trust after October 9, 1969.* With respect to property transferred in trust after October 9, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section 674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor, or his spouse, or a nonadverse party, or any combination thereof (without the approval or consent of any adverse party other than the grantor's spouse) may be:

(i) Distributed to the grantor or the grantor's spouse;

(ii) Held or accumulated for future distribution to the grantor or the grantor's spouse; or

(iii) Applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distribution to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

(c) *Constructive distribution; cessation of interest.* Under section 677 the grantor is treated as the owner of a portion of a trust if he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from that portion distributed to him at some time either actually or constructively (subject to the exception described in paragraph (e) of this section). In the case of a transfer in trust after October 9, 1969, the grantor is also treated as the owner of a portion of a trust if he has granted or retained any interest which might, without the approval or consent of an adverse party (other than the grantor's spouse), enable his spouse to have the income from the portion at some time, whether or not within the grantor's lifetime, distributed to the spouse either actually or constructively. See paragraph (b)(2) of this section for additional rules relating to the income of a trust prior to the grantor's marriage to a beneficiary. Constructive distribution to the grantor or to his spouse includes payment on behalf of the grantor or his spouse to another in obedience to his or her direction and payment of premiums upon policies of insurance on the grantor's, or his spouse's, life (other than policies of insurance irrevocably payable for charitable purposes specified in section 170(c)). If the grantor (in the case of property transferred prior to Oct. 10, 1969) or the grantor and his spouse (in the case of property transferred after

Oct. 9, 1969) are divested permanently and completely of every interest described in this paragraph, the grantor is not treated as an owner under section 677 after that divesting. The word ''interest'' as used in this paragraph does not include the possibility that the grantor or his spouse might receive back from a beneficiary an interest in a trust by inheritance. Further, with respect to transfers in trust prior to October 10, 1969, the word ''interest'' does not include the possibility that the grantor might receive back from a beneficiary an interest in a trust as a surviving spouse under a statutory right of election or a similar right.

(d) *Discharge of legal obligation of grantor or his spouse.* Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969). However, see § 1.677(b)–1 for special rules for trusts whose income may not be applied for the discharge of any legal obligation of the grantor or the grantor's spouse other than the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or grantor's spouse is legally obligated to support. See § 301.7701–4(e) of this chapter for rules on the classification of and application of section 677 to an environmental remediation trust.

(e) *Exception for certain discretionary rights affecting income.* The last sentence of section 677(a) provides that a grantor shall not be treated as the owner when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time during which a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. For example, if the ordinary income of a trust is payable to B for 10 years and then in the grantor's discretion income or corpus may be paid to B or to the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969), the grantor is not treated as an owner with respect to the ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673(d)–1 are applicable in determining whether the grantor should be treated as an owner during the period following the postponement.

(f) *Accumulation of income.* If income is accumulated in any taxable year for future distribution to the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969), section 677(a)(2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969) must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor, or his spouse in the case of property transferred in trust after October 9, 1969, or a nonadverse party, may be, distributed to the grantor (or his spouse in the case of property transferred in trust after Oct. 9, 1969), the grantor is treated as the owner of the trust from its inception. If income attributable to transfers after October 9, 1969 is accumulated in any taxable year during the grantor's lifetime for future distribution to his spouse, section 677(a)(2) treats the grantor as an owner for that taxable year even though his spouse may not receive or exercise discretion over such income prior to the grantor's death.

(g) *Examples.* The application of section 677(a) may be illustrated by the following examples:

Example 1. G creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has the following items of gross income and deductions:

Dividends	$5,000
Capital gain	1,000
Expenses allocable to income	200
Expenses allocable to corpus	100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the $5,000 of dividends, $200 income expense, and $100 corpus expense in the computation of his taxable income for 1970. He should not include the $1,000 capital gain since that is not attributable to the portion of the trust that he owns. See §1.671–3(b). The tax consequences of the capital gain are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of such subparts.

Example 2. G creates a trust which provides that the ordinary income is payable to his adult son. Ten years and one day from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G. In addition, G retains a discretionary right to receive $5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retained no other right or power which would cause him to be treated as an owner under subpart E (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust had the following items of income and deductions:

Dividends	$10,000
Capital gain	2,000
Expenses allocable to income	400
Expenses allocable to corpus	200

Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. See §1.671–3(b).

Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.) In addition, because of G's discretionary right (whether exercised or not) he is treated as the owner of a portion of the trust which will permit a distribution of income to him of $5,000. Accordingly, G includes dividends of $5,208.33 and income expenses of $208.33 in computing his taxable income, determined in the following manner:

Total dividends	$10,000.00
Less: Expenses allocable to income	400.00
Distributable income of the trust	9,600.00
Portion of dividends attributable to G (5,000/9,600×$10,000)	5,208.33
Portion of income expenses attributable to G (5,000/9,600× $400)	208.33
Amount of income subject to discretionary right	5,000.00

In accordance with §1.671–3(c), G also takes into account $104.17 (5,000/9,600×$200) of corpus expenses in computing his tax liability. The portion of the dividends and expenses of the trust not attributable to G are governed by the provisions of subparts A through D.

[T.D. 7148, 36 FR 20749, Oct. 29, 1971, as amended by T.D. 8668, 61 FR 19191, May 1, 1996]

§ 1.677(b)–1 Trusts for support.

(a) Section 677(b) provides that a grantor is not treated as the owner of a trust merely because its income may in the discretion of any person other than the grantor (except when he is acting as trustee or cotrustee) be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse in the case of income from property transferred in trust after October 9, 1969), such as the child of the grantor, whom the grantor or his spouse is legally obligated to support. If income of the current year of the trust is actually so applied or distributed the grantor may be treated as the owner of any portion of the trust under section 677 to that extent, even though it might have been applied or distributed for other purposes. In the case of property transferred to a trust before October 10, 1969, for the benefit of the grantor's spouse, the grantor may be treated as the owner to the extent income of the current year is actually applied for the support or maintenance of his spouse.

(b) If any amount applied or distributed for the support of a beneficiary, including the grantor's spouse in the case of property transferred in trust before October 10, 1969, whom the grantor is legally obligated to support is paid out of corpus or out of income other than income of the current year, the grantor is treated as a beneficiary of the trust, and the amount applied or distributed is considered to be an amount paid within the meaning of section 661(a)(2), taxable to the grantor under section 662. Thus, he is subject to the other relevant portions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Accordingly, the grantor may be taxed on an accumulation distribution or a capital gain distribution under subpart D (section 665 and following) of such part I. Those provisions are applied on the basis that the grantor is the beneficiary.

(c) For the purpose of determining the items of income, deduction, and credit of a trust to be included under this section in computing the grantor's tax liability, the income of the trust for the taxable year of distribution will be deemed to have been first distributed. For example, in the case of a trust reporting on the calendar year basis, a distribution made on January 1, 1956, will be deemed to have been made out of ordinary income of the trust for the calendar year 1956 to the extent of the income for that year even though the trust had received no income as of January 1, 1956. Thus, if a distribution of $10,000 is made on January 1, 1956, for the support of the grantor's dependent, the grantor will be treated as the owner of the trust for 1956 to that extent. If the trust received dividends of $5,000 and incurred expenses of $1,000 during that year but subsequent to January 1, he will take into account dividends of $5,000 and expenses of $1,000 in computing his tax liability for 1956. In addition, the grantor will be treated as a beneficiary of the trust with respect to the $6,000 ($10,000 less distributable income of $4,000 (dividends of $5,000 less expenses of $1,000)) paid out of corpus or out of other than income of the current year. See paragraph (b) of this section.

(d) The exception provided in section 677(b) relates solely to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary. Consequently, the general rule of section 677(a) is applicable when in the discretion of the grantor or nonadverse parties income of a trust may be applied in discharge of a grantor's obligations other than his obligation of support or maintenance falling within section 677(b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied in the payment of the grantor's debts, such as the payment of his rent or other household expenses, he is treated as an owner of the trust regardless of whether the income is actually so applied.

(e) The general rule of section 677(a), and not section 677(b), is applicable if discretion to apply or distribute income of a trust rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as trustee or cotrustee.

(f) The general rule of section 677(a), and not section 677(b), is applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7148, 36 FR 20750, Oct. 29, 1971]

§ 1.678(a)–1 Person other than grantor treated as substantial owner; general rule.

(a) Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, except as provided in section 678(b) (involving taxation of the grantor) and section 678(c) (involving and obligation of support). The holder of such a power also is treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under sections 671 to 677, inclusive. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.

(b) Section 678(a) treats a person as an owner of a trust if he has a power exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations, other than an obligation to support a dependent (see § 1.678(c)–1 subject to the limitation of section 678(b). Section 678 does not apply if the power is not exercisable solely by himself. However, see § 1.662(a)–4 for principles applicable to income of a trust which, pursuant to the terms of the trust instrument, is used to satisfy the obligations of a person other than the grantor.

§ 1.678(b)–1 If grantor is treated as the owner.

Section 678(a) does not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is treated as the owner under sections 671 to 677, inclusive.

§ 1.678(c)–1 Trusts for support.

(a) Section 678(a) does not apply to a power which enables the holder, in the capacity of trustee or cotrustee, to apply the income of the trust to the support or maintenance of a person whom the holder is obligated to support, except to the extent the income is so applied. See paragraphs (a), (b), and (c) of § 1.677(b)–1 for applicable principles where any amount is applied for the support or maintenance of a person whom the holder is obligated to support.

(b) The general rule in section 678(a) (and not the exception in section 678(c)) is applicable in any case in which the holder of a power exercisable solely by himself is able, in any capacity other than that of trustee or cotrustee, to apply the income in discharge of his obligation of support or maintenance.

(c) Section 678(c) is concerned with the taxability of income subject to a power described in section 678(a). It has no application to the taxability of income which is either required to be applied pursuant to the terms of the trust instrument or is applied pursuant to a power which is not described in section 678(a), the taxability of such income being governed by other provisions of the Code. See § 1.662(a)–4.

§ 1.678(d)–1 Renunciation of power.

Section 678(a) does not apply to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

§ 1.679–0 Outline of major topics.

This section lists the major paragraphs contained in §§ 1.679–1 through 1.679–7 as follows:

§ 1.679–1 U.S. transferor treated as owner of foreign trust.

(a) In general.
(b) Interaction with sections 673 through 678.
(c) Definitions.
(1) U.S. transferor.
(2) U.S. person.
(3) Foreign trust.
(4) Property.
(5) Related person.
(6) Obligation.
(d) Examples.

§ 1.679–2 Trusts treated as having a U.S. beneficiary.

(a) Existence of U.S. beneficiary.
(1) In general.
(2) Benefit to a U.S. person
(i) In general.
(ii) Certain unexpected beneficiaries.
(iii) Examples.
(3) Changes in beneficiary's status.
(i) In general.
(ii) Examples.
(4) General rules.
(i) Records and documents.
(ii) Additional factors.
(iii) Examples.
(b) Indirect U.S. beneficiaries.
(1) Certain foreign entities.
(2) Other indirect beneficiaries.
(3) Examples.
(c) Treatment of U.S. transferor upon foreign trust's acquisition or loss of U.S. beneficiary.
(1) Trusts acquiring a U.S. beneficiary.
(2) Trusts ceasing to have a U.S. beneficiary.
(3) Examples.

§ 1.679–3 Transfers.

(a) In general.
(b) Transfers by certain trusts.
(1) In general.
(2) Example.
(c) Indirect transfers.
(1) Principal purpose of tax avoidance.
(2) Principal purpose of tax avoidance deemed to exist.
(3) Effect of disregarding intermediary.

[T.D. 8955, 66 FR 37889, July 20, 2001]

§ 1.679–1 U.S. transferor treated as owner of foreign trust.

(a) *In general.* A U.S. transferor who transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to the property transferred if there is a U.S. beneficiary of any portion of the trust, unless an exception in § 1.679–4 applies to the transfer.

(b) *Interaction with sections 673 through 678.* The rules of this section apply without regard to whether the U.S. transferor retains any power or interest described in sections 673 through 677. If a U.S. transferor would be treated as the owner of a portion of a foreign trust pursuant to the rules of this section and another person would be treated as the owner of the same portion of the trust pursuant to section 678, then the U.S. transferor is treated as the owner and the other person is not treated as the owner.

(c) *Definitions.* The following definitions apply for purposes of this section and §§ 1.679–2 through 1.679–7:

(1) *U.S. transferor.* The term *U.S. transferor* means any U.S. person who makes a transfer (as defined in § 1.679–3) of property to a foreign trust.

(2) *U.S. person.* The term *U.S. person* means a United States person as defined in section 7701(a)(30), a nonresident alien individual who elects under section 6013(g) to be treated as a resident of the United States, and an individual who is a dual resident taxpayer within the meaning of § 301.7701(b)–7(a) of this chapter.

(3) *Foreign trust.* Section 7701(a)(31)(B) defines the term *foreign trust.* See also § 301.7701–7 of this chapter.

(4) *Property.* The term *property* means any property including cash.

(5) *Related person.* A person is a *related person* if, without regard to the transfer at issue, the person is—

(i) A grantor of any portion of the trust (within the meaning of § 1.671–2(e)(1));

(ii) An owner of any portion of the trust under sections 671 through 679;

(iii) A beneficiary of the trust; or

(iv) A person who is related (within the meaning of section 643(i)(2)(B)) to any grantor, owner or beneficiary of the trust.

(6) *Obligation.* The term *obligation* means any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other evidence of indebtedness, and, to the extent not previously described, any annuity contract.

(d) *Examples.* The following examples illustrate the rules of paragraph (a) of this section. In these examples, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, *C* is *A*'s father, who is a resident alien, *D* is *A*'s uncle, who is a nonresident alien, and *FT* is a foreign trust. The examples are as follows:

Example 1. Interaction with section 678. A creates and funds *FT. FT* may provide for the education of *B* by paying for books, tuition, room and board. In addition, *C* has the power to vest the trust corpus or income in himself within the meaning of section 678(a)(1). Under paragraph (b) of this section, *A* is treated as the owner of the portion of *FT* attributable to the property transferred to *FT* by *A* and *C* is not treated as the owner thereof.

Example 2. U.S. person treated as owner of a portion of FT. D creates and funds *FT* for the benefit of *B. D* retains a power described in section 676 and §1.672(f)–3(a)(1). *A* transfers property to *FT.* Under sections 676 and 672(f), *D* is treated as the owner of the portion of *FT* attributable to the property transferred by *D.* Under paragraph (a) of this section, *A* is treated as the owner of the portion of *FT* attributable to the property transferred by *A.*

[T.D. 8955, 66 FR 37889, July 20, 2001]

§ 1.679–2 Trusts treated as having a U.S. beneficiary.

(a) *Existence of U.S. beneficiary*—(1) *In general.* The determination of whether a foreign trust has a U.S. beneficiary is made on an annual basis. A foreign trust is treated as having a U.S. beneficiary unless during the taxable year of the U.S. transferor—

(i) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and

(ii) If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.

(2) *Benefit to a U.S. person*—(i) *In general.* For purposes of paragraph (a)(1) of this section, income or corpus may be paid or accumulated to or for the benefit of a U.S. person during a taxable year of the U.S. transferor if during that year, directly or indirectly, income may be distributed to, or accumulated for the benefit of, a U.S. person, or corpus may be distributed to, or held for the future benefit of, a U.S. person. This determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event.

(ii) *Certain unexpected beneficiaries.* Notwithstanding paragraph (a)(2)(i) of this section, for purposes of paragraph (a)(1) of this section, a person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest in the trust is so remote as to be negligible. The preceding sentence does not apply with respect to persons to whom distributions could be made pursuant to a grant of discretion to the trustee or any other person. A class of beneficiaries generally does not include heirs who will benefit from the trust under the laws of intestate succession in the event that the named beneficiaries (or members of the named class) have all deceased (whether or not stated as a named class in the trust instrument).

(iii) *Examples.* The following examples illustrate the rules of paragraphs (a)(1) and (2) of this section. In these examples, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, *C* is *A*'s daughter, who is a nonresident alien, and *FT* is a foreign trust. The examples are as follows:

Example 1. Distribution of income to U.S. person. A transfers property to *FT.* The trust instrument provides that all trust income is to be distributed currently to *B.* Under paragraph (a)(1) of this section, *FT* is treated as having a U.S. beneficiary.

Example 2. Income accumulation for the benefit of a U.S. person. In 2001, *A* transfers property to *FT.* The trust instrument provides that from 2001 through 2010, the trustee of *FT* may distribute trust income to *C* or may accumulate the trust income. The trust instrument further provides that in 2011, the trust will terminate and the trustee may distribute the trust assets to either or both of *B* and *C,* in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust assets must be distributed to *C.* Because it is possible that income may be accumulated in each year, and that the accumulated income ultimately may be distributed to *B,* a U.S. person, under paragraph (a)(1) of this section *FT* is treated as having a U.S. beneficiary during each of *A*'s tax years from 2001 through 2011. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 3. Corpus held for the benefit of a U.S. person. The facts are the same as in Example 2, except that from 2001 through 2011, all trust income must be distributed to *C*. In 2011, the trust will terminate and the trustee may distribute the trust corpus to either or both of *B* and *C*, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust corpus must be distributed to *C*. Because during each of *A*'s tax years from 2001 through 2011 trust corpus is held for possible future distribution to *B*, a U.S. person, under paragraph (a)(1) of this section *FT* is treated as having a U.S. beneficiary during each of those years. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 4. Distribution upon U.S. transferor's death. A transfers property to *FT*. The trust instrument provides that all trust income must be distributed currently to *C* and, upon *A*'s death, the trust will terminate and the trustee may distribute the trust corpus to either or both of *B* and *C*. Because *B* may receive a distribution of corpus upon the termination of *FT*, and *FT* could terminate in any year, *FT* is treated as having a U.S. beneficiary in the year of the transfer and in subsequent years.

Example 5. Distribution after U.S. transferor's death. The facts are the same as in *Example 4*, except the trust instrument provides that the trust will not terminate until the year following *A*'s death. Upon termination, the trustee may distribute the trust assets to either or both of *B* and *C*, in the trustee's discretion. All trust assets are invested in the stock of *X*, a foreign corporation, and *X* makes no distributions to *FT*. Although no U.S. person may receive a distribution until the year after *A*'s death, and *FT* has no realized income during any year of its existence, during each year in which *A* is living corpus may be held for future distribution to *B*, a U.S. person. Thus, under paragraph (a)(1) of this section *FT* is treated as having a U.S. beneficiary during each of *A*'s tax years from 2001 through the year of *A*'s death.

Example 6. Constructive benefit to U.S. person. A transfers property to *FT*. The trust instrument provides that no income or corpus may be paid directly to a U.S. person. However, the trust instrument provides that trust corpus may be used to satisfy *B*'s legal obligations to a third party by making a payment directly to the third party. Under paragraphs (a)(1) and (2) of this section, *FT* is treated as having a U.S. beneficiary.

Example 7. U.S. person with negligible contingent interest. A transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *C*, and upon *C*'s death, all corpus is to be distributed to whomever of *C*'s three children is then living. All of *C*'s children are nonresident aliens. Under the laws of intestate succession that would apply to *FT*, if all of *C*'s children are deceased at the time of *C*'s death, the corpus would be distributed to *A*'s heirs. *A*'s living relatives at the time of the transfer consist solely of two brothers and two nieces, all of whom are nonresident aliens, and two first cousins, one of whom, *E*, is a U.S. citizen. Although it is possible under certain circumstances that *E* could receive a corpus distribution under the applicable laws of intestate succession, for each year the trust is in existence *A* is able to demonstrate to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that *E*'s contingent interest in *FT* is so remote as to be negligible. Provided that paragraph (a)(4) of this section does not require a different result, *FT* is not treated as having a U.S. beneficiary.

Example 8. U.S. person with non-negligible contingent interest. A transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *D*, *A*'s uncle, who is a nonresident alien, and upon *A*'s death, the corpus is to be distributed to *D* if he is then living. Under the laws of intestate succession that would apply to *FT*, *B* and *C* would share equally in the trust corpus if *D* is not living at the time of *A*'s death. *A* is unable to demonstrate to the satisfaction of the Commissioner that *B*'s contingent interest in the trust is so remote as to be negligible. Under paragraph (a)(2)(ii) of this section, *FT* is treated as having a U.S. beneficiary as of the year of the transfer.

Example 9. U.S. person as member of class of beneficiaries. A transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *D*, *A*'s uncle, who is a nonresident alien, and upon *A*'s death, the corpus is to be distributed to *D* if he is then living. If *D* is not then living, the corpus is to be distributed to *D*'s descendants. *D*'s grandson, *E*, is a resident alien. Under paragraph (a)(2)(ii) of this section, *FT* is treated as having a U.S. beneficiary as of the year of the transfer.

Example 10. Trustee's discretion in choosing beneficiaries. A transfers property to *FT*. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of, any person who is pursuing the academic study of ancient Greek, in the trustee's discretion. Because it is possible that a U.S. person will receive distributions of income or corpus, or will have income accumulated for his benefit, *FT* is treated as having a U.S. beneficiary. This result applies even if, during a tax year, no distributions or accumulations are actually made to or for the benefit of a

U.S. person. *A* may not invoke paragraph (a)(2)(ii) of this section because a U.S. person could benefit pursuant to a grant of discretion in the trust instrument.

Example 11. Appointment of remainder beneficiary. *A* transfers property to *FT*. The trust instrument provides that the trustee may distribute current income to *C*, or may accumulate income, and, upon termination of the trust, trust assets are to be distributed to *C*. However, the trust instrument further provides that *D*, *A*'s uncle, may appoint a different remainder beneficiary. Because it is possible that a U.S. person could be named as the remainder beneficiary, and because corpus could be held in each year for the future benefit of that U.S. person, *FT* is treated as having a U.S. beneficiary for each year.

Example 12. Trust not treated as having a U.S. beneficiary. *A* transfers property to *FT*. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of *C*. Upon termination of the trust, all income and corpus must be distributed to *C*. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that *A* establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Because no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, either directly or indirectly, a U.S. person, and if the trust is terminated no part of the income or corpus of the trust could be paid to or for the benefit of, either directly or indirectly, a U.S. person, *FT* is not treated as having a U.S. beneficiary.

Example 13. U.S. beneficiary becomes non-U.S. person. In 2001, *A* transfers property to *FT*. The trust instrument provides that, as long as *B* remains a U.S. resident, no distributions of income or corpus may be made from the trust to *B*. The trust instrument further provides that if *B* becomes a nonresident alien, distributions of income (including previously accumulated income) and corpus may be made to him. If *B* remains a U.S. resident at the time of *FT*'s termination, all accumulated income and corpus is to be distributed to *C*. In 2007, *B* becomes a nonresident alien and remains so thereafter. Because income may be accumulated during the years 2001 through 2007 for the benefit of a person who is a U.S. person during those years, *FT* is treated as having a U.S. beneficiary under paragraph (a)(1) of this section during each of those years. This result applies even though *B* cannot receive distributions from *FT* during the years he is a resident alien and even though *B* might remain a resident alien who is not entitled to any distribution from *FT*. Provided that paragraph (a)(4) of this section does not require a different result and that *A* establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no other U.S. persons are reasonably expected to benefit from the trust, *FT* is not treated as having a U.S. beneficiary under paragraph (a)(1) of this section during tax years after 2007.

(3) *Changes in beneficiary's status*—(i) *In general.* For purposes of paragraph (a)(1) of this section, the possibility that a person that is not a U.S. person could become a U.S. person will not cause that person to be treated as a U.S. person for purposes of paragraph (a)(1) of this section until the tax year of the U.S. transferor in which that individual actually becomes a U.S. person. However, if a person who is not a U.S. person becomes a U.S. person for the first time more than 5 years after the date of a transfer to the foreign trust by a U.S. transferor, that person is not treated as a U.S. person for purposes of applying paragraph (a)(1) of this section with respect to that transfer.

(ii) *Examples.* The following examples illustrate the rules of paragraph (a)(3) of this section. In these examples, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, *C* is *A*'s daughter, who is a nonresident alien, and *FT* is a foreign trust. The examples are as follows:

Example 1. Non-U.S. beneficiary becomes U.S. person. In 2001, *A* transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *C* and that, upon the termination of *FT*, all corpus is to be distributed to *C*. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that A establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Under paragraph (a)(3)(i) of this section, *FT* is not treated as having a U.S. beneficiary during the tax years of *A* in which *C* remains a nonresident alien. If *C* first becomes a resident alien in 2004, *FT* is treated as having a U.S. beneficiary commencing in that year under paragraph (a)(3) of this section. See paragraph (c) of this section regarding the treatment of *A* upon *FT*'s acquisition of a U.S. beneficiary.

Example 2. Non-U.S. beneficiary becomes U.S. person more than 5 years after transfer. The facts are the same as in *Example 1*, except *C* first becomes a resident alien in 2007. *FT* is treated as not having a U.S. beneficiary under paragraph (a)(3)(i) of this section with respect to the property transfer by *A*. However, if *C* had previously been a U.S. person during any prior period, the 5-year exception in paragraph (a)(3)(i) of this section would not apply in 2007 because it would not have been the first time *C* became a U.S. person.

(4) *General rules*—(i) *Records and documents.* Even if, based on the terms of the trust instrument, a foreign trust is not treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of this section, the trust may nevertheless be treated as having a U.S. beneficiary pursuant to paragraph (a)(1) of this section based on the following—

(A) All written and oral agreements and understandings relating to the trust;

(B) Memoranda or letters of wishes;

(C) All records that relate to the actual distribution of income and corpus; and

(D) All other documents that relate to the trust, whether or not of any purported legal effect.

(ii) *Additional factors.* For purposes of determining whether a foreign trust is treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of this section, the following additional factors are taken into account—

(A) If the terms of the trust instrument allow the trust to be amended to benefit a U.S. person, all potential benefits that could be provided to a U.S. person pursuant to an amendment must be taken into account;

(B) If the terms of the trust instrument do not allow the trust to be amended to benefit a U.S. person, but the law applicable to a foreign trust may require payments or accumulations of income or corpus to or for the benefit of a U.S. person (by judicial reformation or otherwise), all potential benefits that could be provided to a U.S. person pursuant to the law must be taken into account, unless the U.S. transferor demonstrates to the satisfaction of the Commissioner that the law is not reasonably expected to be applied or invoked under the facts and circumstances; and

(C) If the parties to the trust ignore the terms of the trust instrument, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a U.S. person must be taken into account.

(iii) *Examples.* The following examples illustrate the rules of paragraph (a)(4) of this section. In these examples, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, *C* is *A*'s daughter, who is a nonresident alien, and *FT* is a foreign trust. The examples are as follows:

Example 1. Amendment pursuant to local law. A creates and funds *FT* for the benefit of *C*. The terms of *FT* (which, according to the trust instrument, cannot be amended) provide that no part of the income or corpus of *FT* may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, either during the existence of *FT* or at the time of its termination. However, pursuant to the applicable foreign law, FT can be amended to provide for additional beneficiaries, and there is an oral understanding between *A* and the trustee that *B* can be added as a beneficiary. Under paragraphs (a)(1) and (a)(4)(ii)(B) of this section, *FT* is treated as having a U.S. beneficiary.

Example 2. Actions in violation of the terms of the trust. A transfers property to *FT*. The trust instrument provides that no U.S. person can receive income or corpus from *FT* during the term of the trust or at the termination of *FT*. Notwithstanding the terms of the trust instrument, a letter of wishes directs the trustee of *FT* to provide for the educational needs of *B*, who is about to begin college. The letter of wishes contains a disclaimer to the effect that its contents are only suggestions and recommendations and that the trustee is at all times bound by the terms of the trust as set forth in the trust instrument. Under paragraphs (a)(1) and (a)(4)(ii)(C) of this section, *FT* is treated as having a U.S. beneficiary.

(b) *Indirect U.S. beneficiaries*—(1) *Certain foreign entities.* For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of—

(i) A controlled foreign corporation, as defined in section 957(a);

(ii) A foreign partnership, if a U.S. person is a partner of such partnership; or

(iii) A foreign trust or estate, if such trust or estate has a U.S. beneficiary (within the meaning of paragraph (a)(1) of this section).

(2) *Other indirect beneficiaries.* For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or

accumulated for the benefit of a U.S. person through an intermediary, such as an agent or nominee, or by any other means where a U.S. person may obtain an actual or constructive benefit.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b). Unless otherwise noted, A is a resident alien. B is A's son and is a resident alien. FT is a foreign trust. The examples are as follows:

Example 1. Trust benefitting foreign corporation. A transfers property to *FT*. The beneficiary of *FT* is *FC*, a foreign corporation. *FC* has outstanding solely 100 shares of common stock. *B* owns 49 shares of the *FC* stock and *FC2*, also a foreign corporation, owns the remaining 51 shares. *FC2* has outstanding solely 100 shares of common stock. *B* owns 49 shares of *FC2* and nonresident alien individuals own the remaining 51 *FC2* shares. *FC* is a controlled foreign corporation (as defined in section 957(a), after the application of section 958(a)(2)). Under paragraphs (a)(1) and (b)(1)(i) of this section, *FT* is treated as having a U.S. beneficiary.

Example 2. Trust benefitting another trust. A transfers property to *FT*. The terms of *FT* permit current distributions of income to *B*. *A* transfers property to another foreign trust, *FT2*. The terms of *FT2* provide that no U.S. person can benefit either as to income or corpus, but permit current distributions of income to *FT*. Under paragraph (a)(1) of this section, *FT* is treated as having a U.S. beneficiary and, under paragraphs (a)(1) and (b)(1)(iii) of this section, *FT2* is treated as having a U.S. beneficiary.

Example 3. Trust benefitting another trust after transferor's death. A transfers property to *FT*. The terms of *FT* require that all income from *FT* be accumulated during *A*'s lifetime. In the year following *A*'s death, a share of *FT* is to be distributed to *FT2*, another foreign trust, for the benefit of *B*. Under paragraphs (a)(1) and (b)(1)(iii) of this section, *FT* is treated as having a U.S. beneficiary beginning with the year of *A*'s transfer of property to *FT*.

Example 4. Indirect benefit through use of debit card. A transfers property to FT. The trust instrument provides that no U.S. person can benefit either as to income or corpus. However, *FT* maintains an account with *FB*, a foreign bank, and *FB* issues a debit card to *B* against the account maintained by *FT* and *B* is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, *FT* is treated as having a U.S. beneficiary.

Example 5. Other indirect benefit. A transfers property to *FT*. *FT* is administered by *FTC*, a foreign trust company. *FTC* forms *IBC*, an international business corporation formed under the laws of a foreign jurisdiction. *IBC* is the beneficiary of *FT*. *IBC* maintains an account with *FB*, a foreign bank. *FB* issues a debit card to *B* against the account maintained by *IBC* and *B* is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, *FT* is treated as having a U.S. beneficiary.

(c) *Treatment of U.S. transferor upon foreign trust's acquisition or loss of U.S. beneficiary*—(1) *Trusts acquiring a U.S. beneficiary.* If a foreign trust to which a U.S. transferor has transferred property is not treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) for any taxable year of the U.S. transferor, but the trust is treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) in any subsequent taxable year, the U.S. transferor is treated as having additional income in the first such taxable year of the U.S. transferor in which the trust is treated as having a U.S. beneficiary. The amount of the additional income is equal to the trust's undistributed net income, as defined in section 665(a), at the end of the U.S. transferor's immediately preceding taxable year and is subject to the rules of section 668, providing for an interest charge on accumulation distributions from foreign trusts.

(2) *Trusts ceasing to have a U.S. beneficiary.* If, for any taxable year of a U.S. transferor, a foreign trust that has received a transfer of property from the U.S. transferor ceases to be treated as having a U.S. beneficiary, the U.S. transferor ceases to be treated as the owner of the portion of the trust attributable to the transfer beginning in the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary (unless the U.S. transferor is treated as an owner thereof pursuant to sections 673 through 677). The U.S. transferor is treated as making a transfer of property to the foreign trust on the first day of the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary. The amount of the property deemed to be transferred to the trust is the portion of the trust attributable to the prior transfer to which paragraph (a)(1) of this section

applied. For rules regarding the recognition of gain on transfers to foreign trusts, see section 684.

(3) *Examples.* The rules of this paragraph (c) are illustrated by the following examples. *A* is a resident alien, *B* is *A's* son, and *FT* is a foreign trust. The examples are as follows:

Example 1. Trust acquiring U.S. beneficiary. (i) In 2001, *A* transfers stock with a fair market value of $100,000 to *FT*. The stock has an adjusted basis of $50,000 at the time of the transfer. The trust instrument provides that income may be paid currently to, or accumulated for the benefit of, *B* and that, upon the termination of the trust, all income and corpus is to be distributed to *B*. At the time of the transfer, *B* is a nonresident alien. *A* is not treated as the owner of any portion of FT under sections 673 through 677. *FT* accumulates a total of $30,000 of income during the taxable years 2001 through 2003. In 2004, *B* moves to the United States and becomes a resident alien. Assume paragraph (a)(4) of this section is not applicable under the facts and circumstances.

(ii) Under paragraph (c)(1) of this section, *A* is treated as receiving an accumulation distribution in the amount of $30,000 in 2004 and immediately transferring that amount back to the trust. The accumulation distribution is subject to the rules of section 668, providing for an interest charge on accumulation distributions.

(iii) Under paragraphs (a)(1) and (3) of this section, beginning in 2005, *A* is treated as the owner of the portion of *FT* attributable to the stock transferred by *A* to *FT* in 2001 (which includes the portion attributable to the accumulated income deemed to be retransferred in 2004).

Example 2. Trust ceasing to have U.S. beneficiary. (i) The facts are the same as in *Example 1.* In 2008, B becomes a nonresident alien. On the date B becomes a nonresident alien, the stock transferred by A to *FT* in 2001 has a fair market value of $125,000 and an adjusted basis of $50,000.

(ii) Under paragraph (c)(2) of this section, beginning in 2009, *FT* is not treated as having a U.S. beneficiary, and *A* is not treated as the owner of the portion of the trust attributable to the prior transfer of stock. For rules regarding the recognition of gain on the termination of ownership status, see section 684.

[T.D. 8955, 66 FR 37889, July 20, 2001]

§ 1.679–3 Transfers.

(a) *In general.* A transfer means a direct, indirect, or constructive transfer.

(b) *Transfers by certain trusts*—(1) *In general.* If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the owner of that portion to the foreign trust.

(2) *Example.* The following example illustrates this paragraph (b):

Example. In 2001, *A*, a U.S. citizen, creates and funds *DT*, a domestic trust. *A* has the power to revest absolutely in himself the title to the property in *DT* and is treated as the owner of *DT* pursuant to section 676. In 2004, *DT* transfers property to *FT*, a foreign trust. *A* is treated as having transferred the property to *FT* in 2004 for purposes of this section.

(c) *Indirect transfers*—(1) *Principal purpose of tax avoidance.* A transfer to a foreign trust by any person (intermediary) to whom a U.S. person transfers property is treated as an indirect transfer by a U.S. person to the foreign trust if such transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of United States tax.

(2) *Principal purpose of tax avoidance deemed to exist.* For purposes of paragraph (c)(1) of this section, a transfer is deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of United States tax if—

(i) The U.S. person is related (within the meaning of paragraph (c)(4) of this section) to a beneficiary of the foreign trust, or has another relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the U.S. transferor would make a transfer to the foreign trust; and

(ii) The U.S. person cannot demonstrate to the satisfaction of the Commissioner that—

(A) The intermediary has a relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the intermediary would make a transfer to the foreign trust;

(B) The intermediary acted independently of the U.S. person;

(C) The intermediary is not an agent of the U.S. person under generally applicable United States agency principles; and

(D) The intermediary timely complied with the reporting requirements of section 6048, if applicable.

(3) *Effect of disregarding intermediary*—(i) *In general.* Except as provided in paragraph (c)(3)(ii) of this section, if a transfer is treated as an indirect transfer pursuant to paragraph (c)(1) of this section, then the intermediary is treated as an agent of the U.S. person, and the property is treated as transferred to the foreign trust by the U.S. person in the year the property is transferred, or made available, by the intermediary to the foreign trust. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the foreign trust.

(ii) *Special rule.* If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the foreign trust under generally applicable United States agency principles, the property will be treated as transferred to the foreign trust in the year the U.S. person transfers the property to the intermediary. The fair market value of the property transferred will be determined as of the date of the transfer by the U.S. person to the intermediary.

(iii) *Effect on intermediary.* If a transfer of property is treated as an indirect transfer under paragraph (c)(1) of this section, the intermediary is not treated as having transferred the property to the foreign trust.

(4) *Related parties.* For purposes of this paragraph (c), a U.S. transferor is treated as related to a U.S. beneficiary of a foreign trust if the U.S. transferor and the beneficiary are related for purposes of section 643(i)(2)(B), with the following modifications—

(i) For purposes of applying section 267 (other than section 267(f)) and section 707(b)(1), ''at least 10 percent'' is used instead of ''more than 50 percent'' each place it appears; and

(ii) The principles of section 267(b)(10), using ''at least 10 percent'' instead of ''more than 50 percent,'' apply to determine whether two corporations are related.

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

Example 1. Principal purpose of tax avoidance. A, a U.S. citizen, creates and funds *FT*, a foreign trust, for the benefit of *A*'s children, who are U.S. citizens. In 2004, *A* decides to transfer an additional 1000X to the foreign trust. Pursuant to a plan with a principal purpose of avoiding the application of section 679, A transfers 1000X to *I*, a foreign person. *I* subsequently transfers 1000X to *FT*. Under paragraph (c)(1) of this section, *A* is treated as having made a transfer of 1000X to *FT*.

Example 2. U.S. person unable to demonstrate that intermediary acted independently. A, a U.S. citizen, creates and funds *FT*, a foreign trust, for the benefit of *A*'s children, who are U.S. citizens. On July 1, 2004, *A* transfers XYZ stock to *D*, *A*'s uncle, who is a nonresident alien. *D* immediately sells the XYZ stock and uses the proceeds to purchase ABC stock. On January 1, 2007, *D* transfers the ABC stock to *FT*. *A* is unable to demonstrate to the satisfaction of the Commissioner, pursuant to paragraph (c)(2) of this section, that *D* acted independently of *A* in making the transfer to *FT*. Under paragraph (c)(1) of this section, *A* is treated as having transferred the ABC stock to FT. Under paragraph (c)(3) of this section, *D* is treated as an agent of *A*, and the transfer is deemed to have been made on January 1, 2007.

Example 3. Indirect loan to foreign trust. A, a U.S. citizen, previously created and funded *FT*, a foreign trust, for the benefit of *A*'s children, who are U.S. citizens. On July 1, 2004, *A* deposits 500X with *FB*, a foreign bank. On January 1, 2005, *FB* loans 450X to *FT*. *A* is unable to demonstrate to the satisfaction of the Commissioner, pursuant to paragraph (c)(2) of this section, that *FB* has a relationship with *FT* that establishes a reasonable basis for concluding that *FB* would make a loan to *FT* or that *FB* acted independently of *A* in making the loan. Under paragraph (c)(1) of this section, *A* is deemed to have transferred 450X directly to *FT* on January 1, 2005. Under paragraph (c)(3) of this section, *FB* is treated as an agent of *A*. For possible exceptions with respect to qualified obligations of the trust, and the treatment of principal repayments with respect to obligations of the trust that are not qualified obligations, see §1.679–4.

Example 4. Loan to foreign trust prior to deposit of funds in foreign bank. The facts are the same as in *Example 3*, except that *A* makes the 500X deposit with *FB* on January 2, 2005, the day after *FB* makes the loan to *FT*. The result is the same as in *Example 3*.

(d) *Constructive transfers*—(1) *In general.* For purposes of paragraph (a) of this section, a constructive transfer includes any assumption or satisfaction of a foreign trust's obligation to a third party.

(2) *Examples.* The rules of this paragraph (d) are illustrated by the following examples. In each example, *A* is

a U.S. citizen and *FT* is a foreign trust. The examples are as follows:

Example 1. Payment of debt of foreign trust. FT owes 1000X to *Y*, an unrelated foreign corporation, for the performance of services by *Y* for *FT*. In satisfaction of *FT*'s liability to *Y*, *A* transfers to *Y* property with a fair market value of 1000X. Under paragraph (d)(1) of this section, *A* is treated as having made a constructive transfer of the property to *FT*.

Example 2. Assumption of liability of foreign trust. FT owes 1000X to *Y*, an unrelated foreign corporation, for the performance of services by *Y* for *FT*. *A* assumes *FT*'s liability to pay *Y*. Under paragraph (d)(1) of this section, *A* is treated as having made a constructive transfer of property with a fair market value of 1000X to *FT*.

(e) *Guarantee of trust obligations*—(1) *In general.* If a foreign trust borrows money or other property from any person who is not a related person (within the meaning of § 1.679–1(c)(5)) with respect to the trust (lender) and a U.S. person (U.S. guarantor) that is a related person with respect to the trust guarantees (within the meaning of paragraph (e)(4) of this section) the foreign trust's obligation, the U.S. guarantor is treated for purposes of this section as a U.S. transferor that has made a transfer to the trust on the date of the guarantee in an amount determined under paragraph (e)(2) of this section. To the extent this paragraph causes the U.S. guarantor to be treated as having made a transfer to the trust, a lender that is a U.S. person shall not be treated as having transferred that amount to the foreign trust.

(2) *Amount transferred.* The amount deemed transferred by a U.S. guarantor described in paragraph (e)(1) of this section is the guaranteed portion of the adjusted issue price of the obligation (within the meaning of § 1.1275–1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of § 1.1273–1(c)).

(3) *Principal repayments.* If a U.S. person is treated under this paragraph (e) as having made a transfer by reason of the guarantee of an obligation, payments of principal to the lender by the foreign trust with respect to the obligation are taken into account on and after the date of the payment in determining the portion of the trust attributable to the property deemed transferred by the U.S. guarantor.

(4) *Guarantee.* For purposes of this section, the term guarantee—

(i) Includes any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another's obligation;

(ii) Encompasses any form of credit support, and includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability; and

(iii) Includes an arrangement reflected in a comfort letter, regardless of whether the arrangement gives rise to a legally enforceable obligation. If an arrangement is contingent upon the occurrence of an event, in determining whether the arrangement is a guarantee, it is assumed that the event has occurred.

(5) *Examples.* The rules of this paragraph (e) are illustrated by the following examples. In all of the examples, A is a U.S. resident and FT is a foreign trust. The examples are as follows:

Example 1. Foreign lender. X, a foreign corporation, loans 1000X of cash to *FT* in exchange for *FT*'s obligation to repay the loan. *A* guarantees the repayment of 600X of *FT*'s obligation. Under paragraph (e)(2) of this section, *A* is treated as having transferred 600X to *FT*.

Example 2. Unrelated U.S. lender. The facts are the same as in *Example 1*, except *X* is a U.S. person that is not a related person within the meaning of § 1.679–1(c)(5). The result is the same as in *Example 1*.

(f) *Transfers to entities owned by a foreign trust*—(1) *General rule.* If a U.S. person is a related person (as defined in § 1.679–1(c)(5)) with respect to a foreign trust, any transfer of property by the U.S. person to an entity in which the foreign trust holds an ownership interest is treated as a transfer of such property by the U.S. person to the foreign trust followed by a transfer of the property from the foreign trust to the entity owned by the foreign trust, unless the U.S. person demonstrates to the satisfaction of the Commissioner that the transfer to the entity is properly attributable to the U.S. person's ownership interest in the entity.

(2) *Examples.* The rules of this paragraph (f) are illustrated by the following examples. In all of the examples, *A* is a U.S. citizen, *FT* is a foreign

trust, and *FC* is a foreign corporation. The examples are as follows:

Example 1. Transfer treated as transfer to trust. A creates and funds *FT,* which is treated as having a U.S. beneficiary under § 1.679–2. *FT* owns all of the outstanding stock of *FC. A* transfers property directly to *FC.* Because *FT* is the sole shareholder of *FC, A* is unable to demonstrate to the satisfaction of the Commissioner that the transfer is properly attributable to *A*'s ownership interest in *FC.* Accordingly, under this paragraph (f), *A* is treated as having transferred the property to *FT,* followed by a transfer of such property by *FT* to *FC.* Under § 1.679–1(a), *A* is treated as the owner of the portion of *FT* attributable to the property treated as transferred directly to *FT.* Under § 1.367(a)–1T(c)(4)(ii), the transfer of property by *FT* to *FC* is treated as a transfer of the property by *A* to *FC.*

Example 2. Transfer treated as transfer to trust. The facts are the same as in *Example 1,* except that *FT* is not treated as having a U.S. beneficiary under § 1.679–2. Under this paragraph (f), *A* is treated as having transferred the property to *FT,* followed by a transfer of such property by *FT* to *FC. A* is not treated as the owner of *FT* for purposes of § 1.679–1(a). For rules regarding the recognition of gain on the transfer, see section 684.

Example 3. Transfer not treated as transfer to trust. A creates and funds *FT. FC* has outstanding solely 100 shares of common stock. *FT* owns 50 shares of *FC* stock, and *A* owns the remaining 50 shares. On July 1, 2001, *FT* and *A* each transfer 1000X to *FC. A* is able to demonstrate to the satisfaction of the Commissioner that *A*'s transfer to *FC* is properly attributable to *A*'s ownership interest in *FC.* Accordingly, under this paragraph (f), *A*'s transfer to *FC* is not treated as a transfer to *FT.*

[T.D. 8955, 66 FR 37889, July 20, 2001]

§ 1.679–4 Exceptions to general rule.

(a) *In general.* Section 1.679–1 does not apply to—

(1) Any transfer of property to a foreign trust by reason of the death of the transferor;

(2) Any transfer of property to a foreign trust described in sections 402(b), 404(a)(4), or 404A;

(3) Any transfer of property to a foreign trust described in section 501(c)(3) (without regard to the requirements of section 508(a)); and

(4) Any transfer of property to a foreign trust to the extent the transfer is for fair market value.

(b) *Transfers for fair market value*—(1) *In general.* For purposes of this section, a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. For purposes of this section, a distribution to a trust with respect to an interest held by such trust in an entity other than a trust or an interest in certain investment trusts described in § 301.7701–4(c) of this chapter, liquidating trusts described in § 301.7701–4(d) of this chapter, or environmental remediation trusts described in § 301.7701–4(e) of this chapter is considered to be a transfer for fair market value.

(2) *Special rule*—(i) *Transfers for partial consideration.* For purposes of this section, if a person transfers property to a foreign trust in exchange for property having a fair market value that is less than the fair market value of the property transferred, the exception in paragraph (a)(4) of this section applies only to the extent of the fair market value of the property received.

(ii) *Example.* This paragraph (b) is illustrated by the following example:

Example. A, a U.S. citizen, transfers property that has a fair market value of 1000X to *FT,* a foreign trust, in exchange for 600X of cash. Under this paragraph (b), § 1.679–1 applies with respect to the transfer of 400X (1000X less 600X) to *FT.*

(c) *Certain obligations not taken into account.* Solely for purposes of this section, in determining whether a transfer by a U.S. transferor that is a related person (as defined in § 1.679–1(c)(5)) with respect to the foreign trust is for fair market value, any obligation (as defined in § 1.679–1(c)(6)) of the trust or a related person (as defined in § 1.679–1(c)(5)) that is not a qualified obligation within the meaning of paragraph (d)(1) of this section shall not be taken into account.

(d) *Qualified obligations*—(1) *In general.* For purposes of this section, an obligation is treated as a qualified obligation only if—

(i) The obligation is reduced to writing by an express written agreement;

(ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation);

(iii) All payments on the obligation are denominated in U.S. dollars;

(iv) The yield to maturity is not less than 100 percent of the applicable Federal rate and not greater that 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter));

(v) The U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. transferor's taxable year for the year of the transfer and is paid within such period); when properly executed and filed, such an agreement is deemed to be consented to for purposes of § 301.6501(c)–1(d) of this chapter; and

(vi) The U.S. transferor reports the status of the loan, including principal and interest payments, on Form 3520 for every year that the loan is outstanding.

(2) *Additional loans.* If, while the original obligation is outstanding, the U.S. transferor or a person related to the trust (within the meaning of § 1.679–1(c)(5)) directly or indirectly obtains another obligation issued by the trust, or if the U.S. transferor directly or indirectly obtains another obligation issued by a person related to the trust, the original obligation is deemed to have the maturity date of any such subsequent obligation in determining whether the term of the original obligation exceeds the specified 5-year term. In addition, a series of obligations issued and repaid by the trust (or a person related to the trust) is treated as a single obligation if the transactions giving rise to the obligations are structured with a principal purpose to avoid the application of this provision.

(3) *Obligations that cease to be qualified.* If an obligation treated as a qualified obligation subsequently fails to be a qualified obligation (e.g., renegotiation of the terms of the obligation causes the term of the obligation to exceed five years), the U.S. transferor is treated as making a transfer to the trust in an amount equal to the original obligation's adjusted issue price (within the meaning of § 1.1275–1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of § 1.1273–1(c)) as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation. If the maturity date is extended beyond five years by reason of the issuance of a subsequent obligation by the trust (or person related to the trust), the amount of the transfer will not exceed the issue price of the subsequent obligation. The subsequent obligation is separately tested to determine if it is a qualified obligation.

(4) *Transfers resulting from failed qualified obligations.* In general, a transfer resulting from a failed qualified obligation is deemed to occur on the date of the subsequent event that causes the obligation to no longer be a qualified obligation. However, based on all of the facts and circumstances, the Commissioner may deem a transfer to have occurred on any date on or after the issue date of the original obligation. For example, if at the time the original obligation was issued, the transferor knew or had reason to know that the obligation would not be repaid, the Commissioner could deem the transfer to have occurred on the issue date of the original obligation.

(5) *Renegotiated loans.* Any loan that is renegotiated, extended, or revised is treated as a new loan, and any transfer of funds to a foreign trust after such renegotiation, extension, or revision

under a pre-existing loan agreement is treated as a transfer subject to this section.

(6) *Principal repayments.* The payment of principal with respect to any obligation that is not treated as a qualified obligation under this paragraph is taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(7) *Examples.* The rules of this paragraph (d) are illustrated by the following examples. In the examples, *A* and *B* are U.S. residents and *FT* is a foreign trust. The examples are as follows:

Example 1. Demand loan. A transfers 500X to *FT* in exchange for a demand note that permits *A* to require repayment by *FT* at any time. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT.* Because *FT's* obligation to *A* could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, §1.679–1 applies with respect to the full 500X transfer to *FT.*

Example 2. Private annuity. A transfers 4000X to *FT* in exchange for an annuity from the foreign trust that will pay *A* 100X per year for the rest of *A*'s life. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT.* Because *FT*'s obligation to *A* could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, §1.679–1 applies with respect to the full 4000X transfer to *FT.*

Example 3. Loan to unrelated foreign trust. B transfers 1000X to *FT* in exchange for an obligation of the trust. The term of the obligation is fifteen years. *B* is not a related person (as defined in §1.679–1(c)(5)) with respect to *FT.* Because *B* is not a related person, the fair market value of the obligation received by *B* is taken into account for purposes of determining whether *B*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section, even though the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section.

Example 4. Transfer for an obligation with term in excess of 5 years. A transfers property that has a fair market value of 5000X to *FT* in exchange for an obligation of the trust. The term of the obligation is ten years. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT.* Because the term of the obligation is greater than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, §1.679–1 applies with respect to the full 5000X transfer to *FT.*

Example 5. Transfer for a qualified obligation. The facts are the same as in *Example 4,* except that the term of the obligation is 3 years. Assuming the other requirements of paragraph (d)(1) of this section are satisfied, the obligation is a qualified obligation and its adjusted issue price is taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section.

Example 6. Effect of subsequent obligation on original obligation. A transfers property that has a fair market value of 1000X to *FT* in exchange for an obligation that satisfies the requirements of paragraph (d)(1) of this section. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT.* Two years later, *A* transfers an additional 2000X to *FT* and receives another obligation from *FT* that has a maturity date four years from the date that the second obligation was issued. Under paragraph (d)(2) of this section, the original obligation is deemed to have the maturity date of the second obligation. Under paragraph (a) of this section, *A* is treated as having made a transfer in an amount equal to the original obligation's adjusted issue price (within the meaning of §1.1275–1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of §1.1273–1(c)) as of the date of issuance of the second obligation. The second obligation is tested separately to determine whether it is a qualified obligation for purposes of applying paragraph (a) of this section to the second transfer.

[T.D. 8955, 66 FR 37889, July 20, 2001]

§ 1.679–5 Pre-immigration trusts.

(a) *In general.* If a nonresident alien individual becomes a U.S. person and the individual has a residency starting date (as determined under section 7701(b)(2)(A)) within 5 years after directly or indirectly transferring property to a foreign trust (the original transfer), the individual is treated as having transferred to the trust on the residency starting date an amount equal to the portion of the trust attributable to the property transferred by the individual in the original transfer.

(b) *Special rules*—(1) *Change in grantor trust status.* For purposes of paragraph (a) of this section, if a nonresident alien individual who is treated as owning any portion of a trust under the provisions of subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, subsequently ceases to be so treated, the individual is treated as having made the original transfer to the foreign trust immediately before the trust ceases to be treated as owned by the individual.

(2) *Treatment of undistributed income.* For purposes of paragraph (a) of this section, the property deemed transferred to the foreign trust on the residency starting date includes undistributed net income, as defined in section 665(a), attributable to the property deemed transferred. Undistributed net income for periods before the individual's residency starting date is taken into account only for purposes of determining the amount of the property deemed transferred.

(c) *Examples.* The rules of this section are illustrated by the following examples:

Example 1. Nonresident alien becomes resident alien. On January 1, 2002, *A*, a nonresident alien individual, transfers property to a foreign trust, *FT*. On January 1, 2006, *A* becomes a resident of the United States within the meaning of section 7701(b)(1)(A) and has a residency starting date of January 1, 2006, within the meaning of section 7701(b)(2)(A). Under paragraph (a) of this section, *A* is treated as a U.S. transferor and is deemed to transfer the property to *FT* on January 1, 2006. Under paragraph (b)(2) of this section, the property deemed transferred to *FT* on January 1, 2006, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property originally transferred.

Example 2. Nonresident alien loses power to revest property. On January 1, 2002, *A*, a nonresident alien individual, transfers property to a foreign trust, *FT*. *A* has the power to revest absolutely in himself the title to such property transferred and is treated as the owner of the trust pursuant to sections 676 and 672(f). On January 1, 2008, the terms of *FT* are amended to remove *A*'s power to revest in himself title to the property transferred, and *A* ceases to be treated as the owner of *FT*. On January 1, 2010, *A* becomes a resident of the United States. Under paragraph (b)(1) of this section, for purposes of paragraph (a) of this section *A* is treated as having originally transferred the property to *FT* on January 1, 2008. Because this date is within five years of *A*'s residency starting date, *A* is deemed to have made a transfer to the foreign trust on January 1, 2010, his residency starting date. Under paragraph (b)(2) of this section, the property deemed transferred to the foreign trust on January 1, 2010, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property deemed transferred.

[T.D. 8955, 66 FR 37889, July 20, 2001]

§ 1.679–6 Outbound migrations of domestic trusts.

(a) *In general.* Subject to the provisions of paragraph (b) of this section, if an individual who is a U.S. person transfers property to a trust that is not a foreign trust, and such trust becomes a foreign trust while the U.S. person is alive, the U.S. individual is treated as a U.S. transferor and is deemed to transfer the property to a foreign trust on the date the domestic trust becomes a foreign trust.

(b) *Amount deemed transferred.* For purposes of paragraph (a) of this section, the property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property previously transferred. Undistributed net income for periods prior to the migration is taken into account only for purposes of determining the portion of the trust that is attributable to the property transferred by the U.S. person.

(c) *Example.* The following example illustrates the rules of this section. For purposes of the example, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, and *DT* is a domestic trust. The example is as follows:

Example. Outbound migration of domestic trust. On January 1, 2002, *A* transfers property to *DT*, for the benefit of *B*. On January 1, 2003, *DT* acquires a foreign trustee who has the power to determine whether and when distributions will be made to *B*. Under section 7701(a)(30)(E) and § 301.7701–7(d)(ii)(A) of this chapter, *DT* becomes a foreign trust on January 1, 2003. Under paragraph (a) of this section, *A* is treated as transferring property to a foreign trust on January 1, 2003. Under paragraph (b) of this section, the property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property deemed transferred.

[T.D. 8955, 66 FR 37889, July 20, 2001]

§ 1.679–7 Effective dates.

(a) *In general.* Except as provided in paragraph (b) of this section, the rules of §§ 1.679–1, 1.679–2, 1.679–3, and 1.679–4 apply with respect to transfers after August 7, 2000.

(b) *Special rules.* (1) The rules of § 1.679–4(c) and (d) apply to an obligation issued after February 6, 1995, whether or not in accordance with a pre-existing arrangement or understanding. For purposes of the rules of § 1.679–4(c) and (d), if an obligation issued on or before February 6, 1995, is modified after that date, and the modification is a significant modification within the meaning of § 1.1001–3, the obligation is treated as if it were issued on the date of the modification. However, the penalty provided in section 6677 applies only to a failure to report transfers in exchange for obligations issued after August 20, 1996.

(2) The rules of § 1.679–5 apply to persons whose residency starting date is after August 7, 2000.

(3) The rules of § 1.679–6 apply to trusts that become foreign trusts after August 7, 2000.

[T.D. 8955, 66 FR 37889, July 20, 2001]

MISCELLANEOUS

§ 1.681(a)–1 Limitation on charitable contributions deductions of trusts; scope of section 681.

Under section 681, the unlimited charitable contributions deduction otherwise allowable to a trust under section 642(c) is, in general, subject to percentage limitations, corresponding to those applicable to contributions by an individual under section 170(b)(1) (A) and (B), under the following circumstances;

(a) To the extent that the deduction is allocable to ''unrelated business income'';

(b) For taxable years beginning before January 1, 1970, if the trust has engaged in a prohibited transaction;

(c) For taxable years beginning before January 1, 1970, if income is accumulated for a charitable purpose and the accumulation is (1) unreasonable, (2) substantially diverted to a noncharitable purpose, or (3) invested against the interests of the charitable beneficiaries.

Further, if the circumstance set forth in paragraph (a) or (c) of this section is applicable, the deduction is limited to income actually paid out for charitable purposes, and is not allowed for income only set aside or to be used for those purposes. If the circumstance set forth in paragraph (b) of this section is applicable, deductions for contributions to the trust may be disallowed. The provisions of section 681 are discussed in detail in §§ 1.681(a)–2 through 1.681(c)–1. For definition of the term ''income'', see section 643(b) and § 1.643(b)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.681(a)–2 Limitation on charitable contributions deduction of trusts with trade or business income.

(a) *In general.* No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. For the purpose of section 681(a) the term *unrelated business income* of a trust means an amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder, if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3). For the purpose of the computation under section 512, the term *unrelated trade or business* includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to ''unrelated business income'', a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section. This partial deduction is subject to the percentage limitations applicable to contributions by an individual under section 170(b)(1) (A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

(b) *Determination of amounts allocable to unrelated business income.* In determining the amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) which are allocable to unrelated business income, and therefore not allowable as a deduction, the following steps are taken:

(1) There is first determined the amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3), but without taking the charitable contributions deduction allowed under section 512(b)(11).

(2) The amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) is then allocated between the amount determined in subparagraph (1) of this paragraph and any other income of the trust. Unless the facts clearly indicate to the contrary, the allocation to the amount determined in subparagraph (1) of this paragraph is made on the basis of the ratio (but not in excess of 100 percent) of the amount determined in subparagraph (1) of this paragraph to the taxable income of the trust, determined without the deduction for personal exemption under section 642(b), the charitable contributions deduction under section 642(c), or the deduction for distributions to beneficiaries under section 661(a).

(3) The amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) which is allocable to unrelated business income as determined in subparagraph (2) of this paragraph, and therefore not allowable as a deduction, is the amount determined in subparagraph (2) of this paragraph reduced by the charitable contributions deduction which would be allowed under section 512(b)(11) if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3).

(c) *Examples.* (1) The application of this section may be illustrated by the following examples, in which it is assumed that the Y charity is not a charitable organization qualifying under section 170(b)(1)(A) (see subparagraph (2) of this paragraph):

Example 1. The X trust has income of $50,000. There is included in this amount a net profit of $31,000 from the operation of a trade or business. The trustee is required to pay half of the trust income to A, an individual, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). The trustee pays each beneficiary $25,000. Under these facts, the unrelated business income of the trust (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512(b)(12)). The deduction otherwise allowable under section 642(c) is $25,000, the amount paid to the Y charity. The portion allocable to the unrelated business income (computed as prescribed in paragraph (b)(2) of this section) is $15,000, that is, an amount which bears the same ratio to $25,000 as $30,000 bears to $50,000. The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (20 percent of $30,000, the charitable contributions deduction which would be allowable under section 512(b)(11)), or $9,000.

Example 2. Assume the same facts as in example 1, except that the trustee has discretion as to the portion of the trust income to be paid to each beneficiary, and the trustee pays $40,000 to A and $10,000 to the Y charity. The deduction otherwise allowable under section 642(c) is $10,000. The portion allocable to the unrelated business income computed as prescribed in paragraph (b)(2) of this section is $6,000, that is, an amount which bears the same ratio to $10,000 as $30,000 bears to $50,000. Since this amount does not exceed the charitable contributions deduction which would be allowable under section 512(b)(11) ($6,000, determined as in example 1), no portion of it is disallowed as a deduction.

Example 3. Assume the same facts as in example 1, except that the terms of the trust instrument require the trustee to pay to the Y charity the trust income, if any, derived from the trade or business, and to pay to A all the trust income derived from other sources. The trustee pays $31,000 to the Y charity and $19,000 to A. The deduction otherwise allowable under section 642(c) is $31,000. Since the entire income from the trade or business is paid to Y charity, the amount allocable to the unrelated business income computed before the charitable contributions deduction under section 512(b)(11) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512(b)(12)). The amount allocable to the unrelated business income and therefore disallowed as a deduction is $24,000 ($30,000 less $6,000).

Example 4. (i) Under the terms of the trust, the trustee is required to pay half of the trust income to A, an individual, for his life, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). Capital gains are allocable to corpus and upon A's death the trust is to terminate and the corpus is to be distributed to the Y charity. The trust has taxable income of $50,000 computed without any deduction for personal exemption, charitable contributions, or distributions. The amount of $50,000 includes $10,000 capital gains, $30,000 ($31,000 less the $1,000 deduction allowed under section 512(b)(12)) unrelated business income (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) and other income of $9,000. The trustee pays each beneficiary $20,000.

(ii) The deduction otherwise allowable under section 642(c) is $30,000 ($20,000 paid to Y charity and $10,000 capital gains allocated to corpus and permanently set aside for charitable purposes). The portion allocable to the unrelated business income is $15,000, that is, an amount which bears the same ratio to $20,000 (the amount paid to Y charity) as $30,000 bears to $40,000 ($50,000 less $10,000 capital gains allocable to corpus). The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (the charitable contributions deduction which would be allowable under section 512(b)(11)), or $9,000.

(2) If, in the examples in subparagraph (1) of this paragraph, the Y charity were a charitable organization qualifying under section 170(b)(1)(A), then the deduction allowable under section 512(b)(11) would be computed at a rate of 30 percent.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962]

§ 1.681(b)–1 Cross reference.

For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see sections 508(d) and 4948(c)(4). See also 26 CFR 1.681(b)–1 and 1.681(c)–1 (rev. as of Apr. 1, 1974) for provisions applying before January 1, 1970.

[T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.682(a)–1 Income of trust in case of divorce, etc.

(a) *In general.* (1) Section 682(a) provides rules in certain cases for determining the taxability of income of trusts as between spouses who are divorced, or who are separated under a decree of separate maintenance or a written separation agreement. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligations the payments are made, except to the extent that the payments are specified to be for the support of the obligor spouse's minor children in the divorce or separate maintenance decree, the separation agreement or the governing trust instrument. For convenience, the beneficiary spouse will hereafter in this section and in § 1.682(b)–1 be referred to as the ''wife'' and the obligor spouse from whom she is divorced or legally separated as the ''husband''. (See section 7701(a)(17).) Thus, under section 682(a) income of a trust:

(i) Which is paid, credited, or required to be distributed to the wife in a taxable year of the wife, and

(ii) Which, except for the provisions of section 682, would be includible in the gross income of her husband,

is includible in her gross income and is not includible in his gross income.

(2) Section 682(a) does not apply in any case to which section 71 applies. Although section 682(a) and section 71 seemingly cover some of the same situations, there are important differences between them. Thus, section 682(a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife, or a written instrument incident to the divorce status or legal separation status, or a written separation agreement. If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in

trust (whether or not out of trust income), while, if section 71 does not apply, section 682(a) requires amounts paid, credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

(3) Section 682(a) is designed to produce uniformity as between cases in which, without section 682(a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his wife or former wife, and other cases in which the income of a so-called alimony trust is taxable to the wife or former wife because of the termination of the husband's obligation. Furthermore, section 682(a) taxes trust income to the wife in all cases in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the trust income or corpus. Section 682(a) applies whether the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 682(a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

Example 1. Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. Under these facts, section 682(a), rather than section 71, is applicable. Under the provisions of section 682(a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part of the income is includible in H's income or deductible by him.

Example 2. H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of $100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers $100,000 of property to W, the $100,000 is not income to W nor deductible by H.

(b) *Alimony trust income designated for support of minor children.* Section 682(a) does not require the inclusion in the wife's income of trust income which the terms of the divorce or separate maintenance decree, separation agreement, or trust instrument fix in terms of an amount of money or a portion of the income as a sum which is payable for the support of minor children of the husband. The portion of the income which is payable for the support of the minor children is includible in the husband's income. If in such a case trust income fixed in terms of an amount of money is to be paid but a lesser amount becomes payable, the trust income is considered to be payable for the support of the husband's minor children to the extent of the sum which would be payable for their support out of the originally specified amount of trust income. This rule is similar to that provided in the case of periodic payments under section 71. See § 1.71–1.

§ 1.682(b)–1 Application of trust rules to alimony payments.

(a) For the purpose of the application of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code, the wife described in section 682 or section 71 who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the benefit of the husband in discharge of his obligations. A wife treated as a beneficiary of a trust under this section is also treated as the beneficiary of such trust for purposes of the tax imposed by section 56 (relating to the minimum tax for tax preferences). For rules relating to the treatment of items of tax preference with respect to a beneficiary of a trust, see § 1.58–3.

(b) A periodic payment includible in the wife's gross income under section

71 attributable to property in trust is included in full in her gross income in her taxable year in which any part is required to be included under section 652 or 662. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of $5,000 is to be paid to the wife by the trustee every December 31 (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the $5,000 distributable on December 31, 1954, $4,000 is payable out of income and $1,000 out of corpus. The actual distribution is made in 1955. Although the periodic payment is received by the wife in 1955, since under section 662 the $4,000 income distributable on December 31, 1954, is to be included in the wife's income for 1954, the $1,000 payment out of corpus is also to be included in her income for 1954.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.682(c)–1 Definitions.

For definitions of the terms ''husband'' and ''wife'' as used in section 682, see section 7701(a)(17) and the regulations thereunder.

§ 1.683–1 Applicability of provisions; general rule.

Part I (section 641 and following), subchapter J, chapter 1 of the Code, applies to estates and trusts and to beneficiaries only with respect to taxable years which begin after December 31, 1953, and end after August 16, 1954 the date of enactment of the Internal Revenue Code of 1954. In the case of an estate or trust, the date on which a trust is created or amended or on which an estate commences, and the taxable years of beneficiaries, grantors, or decedents concerned are immaterial. This provision applies equally to taxable years of normal and of abbreviated length.

§ 1.683–2 Exceptions.

(a) In the case of any beneficiary of an estate or trust, sections 641 through 682 do not apply to any amount paid, credited, or to be distributed by an estate or trust in any taxable year of the estate or trust which begins before January 1, 1954, or which ends before August 17, 1954. Whether an amount so paid, credited, or to be distributed is to be included in the gross income of a beneficiary is determined with reference to the Internal Revenue Code of 1939. Thus, if a trust in its fiscal year ending June 30, 1954, distributed its current income to a beneficiary on June 30, 1954, the extent to which the distribution is includible in the beneficiary's gross income for his taxable year (the calendar year 1954) and the character of such income will be determined under the Internal Revenue Code of 1939. The Internal Revenue Code of 1954, however, determines the beneficiary's tax liability for a taxable year of the beneficiary to which such Code applies, with respect even to gross income of the beneficiary determined under the Internal Revenue Code of 1939 in accordance with this paragraph. Accordingly, the beneficiary is allowed credits and deductions pursuant to the Internal Revenue Code of 1954 for a taxable year governed by the Internal Revenue Code of 1954. See subparagraph (ii) of example (1) in paragraph (c) of this section.

(b) For purposes of determining the time of receipt of dividends under sections 34 (for purposes of the credit for dividends received on or before December 31, 1964) and 116, the dividends paid, credited, or to be distributed to a beneficiary are deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

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

Example 1. (i) A trust, reporting on the fiscal year basis, receives in its taxable year ending November 30, 1954, dividends on December 3, 1953, and April 3, July 5, and October 4, 1954. It distributes the dividends to A, its sole beneficiary (who reports on the calendar year basis) on November 30, 1954. Since the trust has received dividends in a taxable year ending after July 31, 1954, it will receive a dividend credit under section 34 with respect to dividends received which otherwise qualify under that section, in this case dividends received on October 4, 1954 (i. e., received after July 31, 1954). See section 7851(a)(1)(C). This credit, however, is reduced to the extent the dividends are allocable to the beneficiary as a result of income being paid, credited, or required to be distributed to him. The trust will also be permitted the dividend exclusion under section 116, since it received its dividends in a taxable year ending after July 31, 1954.

(ii) A is entitled to the section 34 credit with respect to the portion of the October 4, 1954, dividends which is distributed to him even though the determination of whether the amount distributed to him is includible in his gross income is made under the Internal Revenue Code of 1939. The credit allowable to the trust is reduced proportionately to the extent A is deemed to have received the October 4 dividends. A is not entitled to a credit with respect to the dividends received by the trust on December 3, 1953, and April 3, and July 5, 1954, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust on dates prior to July 31, 1954. In determining the exclusion under section 116 to which he is entitled, all the dividends received by the trust in 1954 and distributed to him are aggregated with any other dividends received by him in 1954, since he is deemed to have received such dividends in 1954 and therefore within a taxable year ending after July 31, 1954. He is not, however, entitled to the exclusion for the dividends received by the trust in December 1953.

Example 2. (i) A simple trust reports on the basis of a fiscal year ending July 31. It receives dividends on October 3, 1953, and January 4, April 3, and July 5, 1954. It distributes the dividends to A, its sole beneficiary, on September 1, 1954. The trust, receiving dividends in a taxable year ending prior to August 17, 1954, is entitled neither to the dividend received credit under section 34 nor the dividend exclusion under section 116.

(ii) A (reporting on the calendar year basis) is not entitled to the section 34 credit, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust, that is, on October 3, 1953, and January 4, April 3, and July 5, 1954. He is, however, entitled to the section 116 exclusion with respect to the dividends received by the trust in 1954 (along with other dividends received by him in 1954) and distributed to him, since he is deemed to have received such dividends on January 4, April 3, and July 5, 1954, each a date in this taxable year ending after July 31, 1954. He is entitled to no exclusion for the dividends received by the trust on October 3, 1953, since he is deemed to receive the resulting distribution on the same date, which falls within a taxable year of his which ends before August 1, 1954, although he is required to include the October 1953 dividends in his 1954 income. See section 164 of the Internal Revenue Code of 1939.

Example 3. A simple trust on a fiscal year ending July 31, 1954, receives dividends August 5 and November 4, 1953. It distributes the dividends to A, its sole beneficiary (who is on a calendar year basis), on September 1, 1954. Neither the trust nor A is entitled to a credit under section 34 or an exclusion under section 116.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964]

§ 1.683–3 Application of the 65-day rule of the Internal Revenue Code of 1939.

If an amount is paid, credited, or to be distributed in the first 65 days of the first taxable year of an estate or trust (heretofore subject to the provisions of the Internal Revenue Code of 1939) to which the Internal Revenue Code of 1954 applies and the amount would be treated, if the Internal Revenue Code of 1939 were applicable, as if paid, credited, or to be distributed on the last day of the preceding taxable year, sections 641 through 682 do not apply to the amount. The amount so paid, credited, or to be distributed is taken into account as provided in the Internal Revenue Code of 1939. See 26 CFR (1939) 39.162–2 (c) and (d) (Regulations 118).

§ 1.684–1 Recognition of gain on transfers to certain foreign trusts and estates.

(a) *Immediate recognition of gain*—(1) *In general.* Any U.S. person who transfers property to a foreign trust or foreign estate shall be required to recognize gain at the time of the transfer equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the U.S. transferor unless an exception applies under the provisions of § 1.684–3. The amount of gain recognized is determined on an asset-by-asset basis.

(2) *No recognition of loss.* Under this section a U.S. person may not recognize loss on the transfer of an asset to a foreign trust or foreign estate. A U.S. person may not offset gain realized on the transfer of an appreciated asset to a foreign trust or foreign estate by a loss realized on the transfer of a depreciated asset to the foreign trust or foreign estate.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *U.S. person.* The term *U.S. person* means a United States person as defined in section 7701(a)(30), and includes a nonresident alien individual who elects under section 6013(g) to be treated as a resident of the United States.

(2) *U.S. transferor.* The term *U.S. transferor* means any U.S. person who makes a transfer (as defined in §1.684–2) of property to a foreign trust or foreign estate.

(3) *Foreign trust.* Section 7701(a)(31)(B) defines foreign trust. See also §301.7701–7 of this chapter.

(4) *Foreign estate.* Section 7701(a)(31)(A) defines foreign estate.

(c) *Reporting requirements.* A U.S. person who transfers property to a foreign trust or foreign estate must comply with the reporting requirements under section 6048.

(d) *Examples.* The following examples illustrate the rules of this section. In all examples, *A* is a U.S. person and *FT* is a foreign trust. The examples are as follows:

Example 1. Transfer to foreign trust. A transfers property that has a fair market value of 1000X to *FT*. *A*'s adjusted basis in the property is 400X. *FT* has no U.S. beneficiary within the meaning of §1.679–2, and no person is treated as owning any portion of *FT*. Under paragraph (a)(1) of this section, *A* recognizes gain at the time of the transfer equal to 600X.

Example 2. Transfer of multiple properties. A transfers property Q, with a fair market value of 1000X, and property R, with a fair market value of 2000X, to *FT*. At the time of the transfer, *A*'s adjusted basis in property Q is 700X, and *A*'s adjusted basis in property R is 2200X. *FT* has no U.S. beneficiary within the meaning of §1.679–2, and no person is treated as owning any portion of *FT*. Under paragraph (a)(1) of this section, *A* recognizes the 300X of gain attributable to property Q. Under paragraph (a)(2) of this section, *A* does not recognize the 200X of loss attributable to property R, and may not offset that loss against the gain attributable to property Q.

Example 3. Transfer for less than fair market value. A transfers property that has a fair market value of 1000X to *FT* in exchange for 400X of cash. *A*'s adjusted basis in the property is 200X. *FT* has no U.S. beneficiary within the meaning of §1.679–2, and no person is treated as owning any portion of *FT*. Under paragraph (a)(1) of this section, *A* recognizes gain at the time of the transfer equal to 800X.

Example 4. Exchange of property for private annuity. A transfers property that has a fair market value of 1000X to *FT* in exchange for *FT*'s obligation to pay A 50X per year for the rest of *A*'s life. *A*'s adjusted basis in the property is 100X. *FT* has no U.S. beneficiary within the meaning of §1.679–2, and no person is treated as owning any portion of *FT*. *A* is required to recognize gain equal to 900X immediately upon transfer of the property to the trust. This result applies even though *A* might otherwise have been allowed to defer recognition of gain under another provision of the Internal Revenue Code.

Example 5. Transfer of property to related foreign trust in exchange for qualified obligation. A transfers property that has a fair market value of 1000X to *FT* in exchange for *FT*'s obligation to make payments to *A* during the next four years. *FT* is related to *A* as defined in §1.679–1(c)(5). The obligation is treated as a qualified obligation within the meaning of §1.679–4(d), and no person is treated as owning any portion of *FT*. *A*'s adjusted basis in the property is 100X. *A* is required to recognize gain equal to 900X immediately upon transfer of the property to the trust. This result applies even though *A* might otherwise have been allowed to defer recognition of gain under another provision of the Internal Revenue Code. Section 1.684–3(d) provides rules relating to transfers for fair market value to unrelated foreign trusts.

[T.D. 8956, 66 FR 37899, July 20, 2001]

§ 1.684–2 Transfers.

(a) *In general.* A transfer means a direct, indirect, or constructive transfer.

(b) *Indirect transfers*—(1) *In general.* Section 1.679–3(c) shall apply to determine if a transfer to a foreign trust or foreign estate, by any person, is treated as an indirect transfer by a U.S. person to the foreign trust or foreign estate.

(2) *Examples.* The following examples illustrate the rules of this paragraph (b). In all examples, *A* is a U.S. citizen, *FT* is a foreign trust, and *I* is *A*'s uncle, who is a nonresident alien. The examples are as follows:

Example 1. Principal purpose of tax avoidance. A creates and funds *FT* for the benefit of *A*'s cousin, who is a nonresident alien. *FT* has no U.S. beneficiary within the meaning of §1.679–2, and no person is treated as owning any portion of *FT*. In 2004, *A* decides to transfer additional property with a fair market value of 1000X and an adjusted basis of 600X to *FT*. Pursuant to a plan with a principal purpose of avoiding the application of section 684, *A* transfers the property to *I*. *I* subsequently transfers the property to *FT*.

Under paragraph (b) of this section and §1.679–3(c), *A* is treated as having transferred the property to *FT*.

Example 2. U.S. person unable to demonstrate that intermediary acted independently. A creates and funds *FT* for the benefit of *A*'s cousin, who is a nonresident alien. *FT* has no U.S. beneficiary within the meaning of §1.679–2, and no person is treated as owning any portion of *FT*. On July 1, 2004, *A* transfers property with a fair market value of 1000X and an adjusted basis of 300X to *I*, a foreign person. On January 1, 2007, at a time when the fair market value of the property is 1100X, *I* transfers the property to *FT*. *A* is unable to demonstrate to the satisfaction of the Commissioner, under §1.679–3(c)(2)(ii), that *I* acted independently of *A* in making the transfer to *FT*. Under paragraph (b) of this section and §1.679–3(c), *A* is treated as having transferred the property to *FT*. Under paragraph (b) of this section and §1.679–3(c)(3), *I* is treated as an agent of *A*, and the transfer is deemed to have been made on January 1, 2007. Under §1.684–1(a), *A* recognizes gain equal to 800X on that date.

(c) *Constructive transfers.* Section 1.679–3(d) shall apply to determine if a transfer to a foreign trust or foreign estate is treated as a constructive transfer by a U.S. person to the foreign trust or foreign estate.

(d) *Transfers by certain trusts*—(1) *In general.* If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the owner of that portion to the foreign trust.

(2) *Examples.* The following examples illustrate the rules of this paragraph (d). In all examples, *A* is a U.S. person, *DT* is a domestic trust, and *FT* is a foreign trust. The examples are as follows:

Example 1. Transfer by a domestic trust. On January 1, 2001, *A* transfers property which has a fair market value of 1000X and an adjusted basis of 200X to *DT*. *A* retains the power to revoke *DT*. On January 1, 2003, *DT* transfers property which has a fair market value of 500X and an adjusted basis of 100X to *FT*. At the time of the transfer, *FT* has no U.S. beneficiary as defined in §1.679–2 and no person is treated as owning any portion of *FT*. *A* is treated as having transferred the property to *FT* and is required to recognize gain of 400X, under §1.684–1, at the time of the transfer by *DT* to *FT*.

Example 2. Transfer by a foreign trust. On January 1, 2001, *A* transfers property which has a fair market value of 1000X and an adjusted basis of 200X to *FT1*. At the time of the transfer, *FT1* has a U.S. beneficiary as defined in §1.679–2 and *A* is treated as the owner of *FT1* under section 679. On January 1, 2003, *FT1* transfers property which has a fair market value of 500X and an adjusted basis of 100X to *FT2*. At the time of the transfer, *FT2* has no U.S. beneficiary as defined in §1.679–2 and no person is treated as owning any portion of *FT2*. *A* is treated as having transferred the property to *FT2* and is required to recognize gain of 400X, under §1.684–1, at the time of the transfer by *FT1* to *FT2*.

(e) *Deemed transfers when foreign trust no longer treated as owned by a U.S. person*—(1) *In general.* If any portion of a foreign trust is treated as owned by a U.S. person under subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, and such portion ceases to be treated as owned by that person under such subpart (other than by reason of an actual transfer of property from the trust to which §1.684–2(d) applies), the U.S. person shall be treated as having transferred, immediately before (but on the same date that) the trust is no longer treated as owned by that U.S. person, the assets of such portion to a foreign trust.

(2) *Examples.* The following examples illustrate the rules of this paragraph (e). In all examples, *A* is a U.S. citizen and *FT* is a foreign trust. The examples are as follows:

Example 1. Loss of U.S. beneficiary.—(i) On January 1, 2001, *A* transfers property, which has a fair market value of 1000X and an adjusted basis of 400X, to *FT*. At the time of the transfer, *FT* has a U.S. beneficiary within the meaning of §1.679–2, and *A* is treated as owning *FT* under section 679. Under §1.684–3(a), §1.684–1 does not cause *A* to recognize gain at the time of the transfer.

(ii) On July 1, 2003, *FT* ceases to have a U.S. beneficiary as defined in §1.679–2(c) and as of that date neither *A* nor any other person is treated as owning any portion of *FT*. Pursuant to §1.679–2(c)(2), if *FT* ceases to be treated as having a U.S. beneficiary, *A* will cease to be treated as owner of *FT* beginning on the first day of the first taxable year following the last taxable year in which there was a U.S. beneficiary. Thus, on January 1, 2004, *A* ceases to be treated as owner of *FT*. On that date, the fair market value of the property is 1200X and the adjusted basis is 350X. Under paragraph (e)(1) of this section, *A* is treated as having transferred the property to *FT* on January 1, 2004, and must recognize 850X of gain at that time under §1.684–1.

Example 2. Death of grantor. (i) The initial facts are the same as in paragraph (i) of *Example 1.*

(ii) On July 1, 2003, *A* dies, and as of that date no other person is treated as the owner of *FT*. On that date, the fair market value of the property is 1200X, and its adjusted basis equals 350X. Under paragraph (e)(1) of this section, *A* is treated as having transferred the property to *FT* immediately before his death, and generally is required to recognize 850X of gain at that time under §1.684–1. However, an exception may apply under §1.684–3(c).

Example 3. Release of a power. (i) On January 1, 2001, *A* transfers property that has a fair market value of 500X and an adjusted basis of 200X to *FT*. At the time of the transfer, *FT* does not have a U.S. beneficiary within the meaning of §1.679–2. However, *A* retains the power to revoke the trust. *A* is treated as the owner of the trust under section 676 and, therefore, under §1.684–3(a), *A* is not required to recognize gain under §1.684–1 at the time of the transfer.

(ii) On January 1, 2007, *A* releases the power to revoke the trust and, as of that date, neither *A* nor any other person is treated as owning any portion of *FT*. On that date, the fair market value of the property is 900X, and its adjusted basis is 200X. Under paragraph (e)(1) of this section, *A* is treated as having transferred the property to *FT* on January 1, 2007, and must recognize 700X of gain at that time.

(f) *Transfers to entities owned by a foreign trust.* Section 1.679–3(f) provides rules that apply with respect to transfers of property by a U.S. person to an entity in which a foreign trust holds an ownership interest.

[T.D. 8956, 66 FR 37899, July 20, 2001]

§ 1.684–3 Exceptions to general rule of gain recognition.

(a) *Transfers to grantor trusts.* The general rule of gain recognition under §1.684–1 shall not apply to any transfer of property by a U.S. person to a foreign trust to the extent that any person is treated as the owner of the trust under section 671. Section 1.684–2(e) provides rules regarding a subsequent change in the status of the trust.

(b) *Transfers to charitable trusts.* The general rule of gain recognition under §1.684–1 shall not apply to any transfer of property to a foreign trust that is described in section 501(c)(3) (without regard to the requirements of section 508(a)).

(c) *Certain transfers at death.* The general rule of gain recognition under §1.684–1 shall not apply to any transfer of property by reason of death of the U.S. transferor if the basis of the property in the hands of the foreign trust is determined under section 1014(a).

(d) *Transfers for fair market value to unrelated trusts.* The general rule of gain recognition under §1.684–1 shall not apply to any transfer of property for fair market value to a foreign trust that is not a related foreign trust as defined in §1.679–1(c)(5). Section 1.671–2(e)(2)(ii) defines fair market value.

(e) *Transfers to which section 1032 applies.* The general rule of gain recognition under §1.684–1 shall not apply to any transfer of stock (including treasury stock) by a domestic corporation to a foreign trust if the domestic corporation is not required to recognize gain on the transfer under section 1032.

(f) *Certain distributions to trusts.* For purposes of this section, a transfer does not include a distribution to a trust with respect to an interest held by such trust in an entity other than a trust or an interest in certain investment trusts described in §301.7701–4(c) of this chapter, liquidating trusts described in §301.7701–4(d) of this chapter, or environmental remediation trusts described in §301.7701–4(e) of this chapter.

(g) *Examples.* The following examples illustrate the rules of this section. In all examples, *A* is a U.S. citizen and *FT* is a foreign trust. The examples are as follows:

Example 1. Transfer to owner trust. In 2001, *A* transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to *FT*. At the time of the transfer, *FT* has a U.S. beneficiary within the meaning of §1.679–2, and *A* is treated as owning *FT* under section 679. Under paragraph (a) of this section, §1.684–1 does not cause *A* to recognize gain at the time of the transfer. See §1.684–2(e) for rules that may require *A* to recognize gain if the trust is no longer owned by *A*.

Example 2. Transfer of property at death: Basis determined under section 1014(a). (i) The initial facts are the same as *Example 1.*

(ii) *A* dies on July 1, 2004. The fair market value at *A*'s death of all property transferred to *FT* by *A* is 1500X. The basis in the property is 400X. *A* retained the power to revoke *FT*, thus, the value of all property owned by *FT* at *A*'s death is includible in *A*'s gross estate for U.S. estate tax purposes. Pursuant to paragraph (c) of this section, *A* is not required to recognize gain under § 1.684–1 because the basis of the property in the hands of the foreign trust is determined under section 1014(a).

Example 3. Transfer of property at death: Basis not determined under section 1014(a).

(i) The initial facts are the same as *Example 1.*

(ii) *A* dies on July 1, 2004. The fair market value at *A*'s death of all property transferred to *FT* by *A* is 1500X. The basis in the property is 400X. *A* retains no power over *FT,* and *FT*'s basis in the property transferred is not determined under section 1014(a). Under § 1.684–2(e)(1), *A* is treated as having transferred the property to *FT* immediately before his death, and must recognize 1100X of gain at that time under § 1.684–1.

Example 4. Transfer of property for fair market value to an unrelated foreign trust. A sells a house with a fair market value of 1000X to *FT* in exchange for a 30-year note issued by *FT. A* is not related to *FT* as defined in § 1.679–1(c)(5). *FT* is not treated as owned by any person. Pursuant to paragraph (d) of this section, *A* is not required to recognize gain under § 1.684–1.

[T.D. 8956, 66 FR 37899, July 20, 2001]

§ 1.684–4 Outbound migrations of domestic trusts.

(a) *In general.* If a U.S. person transfers property to a domestic trust, and such trust becomes a foreign trust, and neither trust is treated as owned by any person under subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, the trust shall be treated for purposes of this section as having transferred all of its assets to a foreign trust and the trust is required to recognize gain on the transfer under § 1.684–1(a). The trust must also comply with the rules of section 6048.

(b) *Date of transfer.* The transfer described in this section shall be deemed to occur immediately before, but on the same date that, the trust meets the definition of a foreign trust set forth in section 7701(a)(31)(B).

(c) *Inadvertent migrations.* In the event of an inadvertent migration, as defined in § 301.7701–7(d)(2) of this chapter, a trust may avoid the application of this section by complying with the procedures set forth in § 301.7701–7(d)(2) of this chapter.

(d) *Examples.* The following examples illustrate the rules of this section. In all examples, *A* is a U.S. citizen, *B* is a U.S. citizen, *C* is a nonresident alien, and *T* is a trust. The examples are as follows:

Example 1. Migration of domestic trust with U.S. beneficiaries. A transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to *T,* a domestic trust, for the benefit of *A*'s children who are also U.S. citizens. *B* is the trustee of *T.* On January 1, 2001, while *A* is still alive, *B* resigns as trustee and *C* becomes successor trustee under the terms of the trust. Pursuant to § 301.7701–7(d) of this chapter, *T* becomes a foreign trust. *T* has U.S. beneficiaries within the meaning of § 1.679–2 and *A* is, therefore, treated as owning *FT* under section 679. Pursuant to § 1.684–3(a), neither *A* nor *T* is required to recognize gain at the time of the migration. Section 1.684–2(e) provides rules that may require *A* to recognize gain upon a subsequent change in the status of the trust.

Example 2. Migration of domestic trust with no U.S. beneficiaries. A transfers property which has a fair market value of 1000X and an adjusted basis equal to 400X to *T,* a domestic trust for the benefit of *A*'s mother who is not a citizen or resident of the United States. *T* is not treated as owned by another person. *B* is the trustee of *T.* On January 1, 2001, while *A* is still alive, *B* resigns as trustee and *C* becomes successor trustee under the terms of the trust. Pursuant to § 301.7701–7(d) of this chapter, *T* becomes a foreign trust, *FT. FT* has no U.S. beneficiaries within the meaning of § 1.679–2 and no person is treated as owning any portion of *FT. T* is required to recognize gain of 600X on January 1, 2001. Paragraph (c) of this section provides rules with respect to an inadvertent migration of a domestic trust.

[T.D. 8956, 66 FR 37899, July 20, 2001]

§ 1.684–5 Effective date.

Sections 1.684–1 through 1.684–4 apply to transfers of property to foreign trusts and foreign estates after August 7, 2000.

[T.D. 8956, 66 FR 37899, July 20, 2001]

INCOME IN RESPECT OF DECEDENTS

§ 1.691(a)–1 Income in respect of a decedent.

(a) *Scope of section 691.* In general, the regulations under section 691 cover: (1) The provisions requiring that amounts which are not includible in gross income for the decedent's last taxable year or for a prior taxable year be included in the gross income of the estate or persons receiving such income to the extent that such amounts constitute ''income in respect of a decedent''; (2) the taxable effect of a transfer of the right to such income; (3) the treatment of certain deductions and credit in respect of a decedent which are not allowable to the decedent for the taxable period ending with his death or for a prior taxable year; (4) the allowance to a recipient of income in respect of a decedent of a deduction for estate taxes attributable to the inclusion of the value of the right to such income in the decedent's estate; (5) special provisions with respect to installment obligations acquired from a decedent and with respect to the allowance of a deduction for estate taxes to a surviving annuitant under a joint and survivor annuity contract; and (6) special provisions relating to installment obligations transmitted at death when prior law applied to the transmission.

(b) *General definition.* In general, the term *income in respect of a decedent* refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes:

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

(3) Income to which the decedent had a contingent claim at the time of his death.

See sections 736 and 753 and the regulations thereunder for ''income in respect of a decedent'' in the case of a deceased partner.

(c) *Prior decedent.* The term *income in respect of a decedent* also includes the amount of all items of gross income in respect of a prior decedent, if (1) the right to receive such amount was acquired by the decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent and if (2) the amount of gross income in respect of the prior decedent was not properly includible in computing the decedent's taxable income for the taxable year ending with the date of his death or for a previous taxable year. See example 2 of paragraph (b) of § 1.691(a)–2.

(d) *Items excluded from gross income.* Section 691 applies only to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income under subtitle A of the Code are not within the provisions of section 691.

(e) *Cross reference.* For items deemed to be income in respect of a decedent for purposes of the deduction for estate taxes provided by section 691(c), see paragraph (c) of § 1.691(c)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6808, 30 FR 3435, Mar. 16, 1965]

§ 1.691(a)–2 Inclusion in gross income by recipients.

(a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of:

(1) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(2) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(3) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

These amounts are included in the income of the estate or of such persons when received by them whether or not they report income by use of the cash receipts and disbursements methods.

(b) The application of paragraph (a) of this section may be illustrated by the following examples, in each of which it is assumed that the decedent kept his books by use of the cash receipts and disbursements method.

Example 1. The decedent was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years. His estate, after collecting two installments, distributed the right to the remaining installment payments to the residuary legatee of the estate. The estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

Example 2. A widow acquired, by bequest from her husband, the right to receive renewal commissions on life insurance sold by him in his lifetime, which commissions were payable over a period of years. The widow died before having received all of such commissions, and her son inherited the right to receive the rest of the commissions. The commissions received by the widow were includible in her gross income. The commissions received by the son were not includible in the widow's gross income but must be included in the gross income of the son.

Example 3. The decedent owned a Series E United States savings bond, with his wife as co-owner or beneficiary, but died before the payment of such bond. The entire amount of interest accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid.

Example 4. A, prior to his death, acquired 10,000 shares of the capital stock of the X Corporation at a cost of $100 per share. During his lifetime, A had entered into an agreement with X Corporation whereby X Corporation agreed to purchase and the decedent agreed that his executor would sell the 10,000 shares of X Corporation stock owned by him at the book value of the stock at the date of A's death. Upon A's death, the shares are sold by A's executor for $500 a share pursuant to the agreement. Since the sale of stock is consummated after A's death, there is no income in respect of a decedent with respect to the appreciation in value of A's stock to the date of his death. If, in this example, A had in fact sold the stock during his lifetime but payment had not been received before his death, any gain on the sale would constitute income in respect of a decedent when the proceeds were received.

Example 5. (1) A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive payment before his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory, but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

(2) Assume that, instead of the transaction entered into with Y, A had disposed of the 1,200 bushels of harvested apples by delivering them to Z, a cooperative association, for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him. After the fruit is processed and the products are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After A's death, the association made distributions to the executor with respect to A's share of the proceeds from the pool in which A had in interest. Under such circumstances, the proceeds from the disposition of the 1,200 bushels of apples constitute income in respect of a decedent.

§ 1.691(a)–3 Character of gross income.

(a) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate, or by the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death, as if it had been acquired in the transaction by which the decedent (or a prior decedent) acquired such right, and shall be considered as having the same character it would have had if the decedent (or a prior decedent) had lived and received such amount. The provisions of section 1014(a), relating to the basis of property acquired from a decedent, do not apply to these amounts in the hands of the estate and such persons. See section 1014(c).

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

(1) If the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the income, when received, shall be treated in the hands of the estate or of such person as capital gain from the sale of the property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), in the same manner as if such person had held the property for the

period the decedent held it, and had made the sale.

(2) If the income is interest on United States obligations which were owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determining the credit provided by section 35, as if such person had owned the obligations with respect to which such interest is paid.

(3) If the amounts received would be subject to special treatment under part I (section 1301 and following), subchapter Q, chapter 1 of the Code, relating to income attributable to serveral taxable years, as in effect for taxable years beginning before January 1, 1964, if the decedent had lived and included such amounts in his gross income, such sections apply with respect to the recipient of the income.

(4) The provisions of sections 632 and 1347, relating to the tax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.691(a)–4 Transfer of right to income in respect of a decedent.

(a) Section 691(a)(2) provides the rules governing the treatment of income in respect of a decedent (or a prior decedent) in the event a right to receive such income is transferred by the estate or person entitled thereto by bequest, devise, or inheritance, or by reason of the death of the decedent. In general, the transferor must include in his gross income for the taxable period in which the transfer occurs the amount of the consideration, if any, received for the right or the fair market value of the right at the time of the transfer, whichever is greater. Thus, upon a sale of such right by the estate or person entitled to receive it, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in the gross income of the vendor. Similarly, if such right is disposed of by gift, the fair market value of the right at the time of the gift must be included in the gross income of the donor. In the case of a satisfaction of an installment obligation at other than face value, which is likewise considered a transfer under section 691(a)(2), see § 1.691(a)–5.

(b) If the estate of a decedent or any person transmits the right to income in respect of a decedent to another who would be required by section 691(a)(1) to include such income when received in his gross income, only the transferee will include such income when received in his gross income. In this situation, a transfer within the meaning of section 691(a)(2) has not occurred. This paragraph may be illustrated by the following:

(1) If a person entitled to income in respect of a decedent dies before receiving such income, only his estate or other person entitled to such income by bequest, devise, or inheritance from the latter decedent, or by reason of the death of the latter decedent, must include such amount in gross income when received.

(2) If a right to income in respect of a decedent is transferred by an estate to a specific or residuary legatee, only the specific or residuary legatee must include such income in gross income when received.

(3) If a trust to which is bequeathed a right of a decedent to certain payments of income terminates and transfers the right to a beneficiary, only the beneficiary must include such income in gross income when received.

If the transferee described in subparagraphs (1), (2), and (3) of this paragraph transfers his right to receive the amounts in the manner described in paragraph (a) of this section, the principles contained in paragraph (a) are applied to such transfer. On the other hand, if the transferee transmits his right in the manner described in this paragraph, the principles of this paragraph are again applied to such transfer.

§ 1.691(a)–5 Installment obligations acquired from decedent.

(a) Section 691(a)(4) has reference to an installment obligation which remains uncollected by a decedent (or a prior decedent) and which was originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453. Under the provisions of section 691(a)(4), an amount equal to the excess of the face value of the obligation over its basis in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) shall be considered an amount of income in respect of a decedent and shall be treated as such. The decedent's estate (or the person entitled to receive such income by bequest or inheritance from the decedent or by reason of the decedent's death) shall include in its gross income when received the same proportion of any payment in satisfaction of such obligations as would be returnable as income by the decedent if he had lived and received such payment. No gain on account of the transmission of such obligations by the decedent's death is required to be reported as income in the return of the decedent for the year of his death. See § 1.691(e)–1 for special provisions relating to the filing of an election to have the provisions of section 691(a)(4) apply in the case of installment obligations in respect of which section 44(d) of the Internal Revenue Code of 1939 (or corresponding provisions of prior law) would have applied but for the filing of a bond referred to therein.

(b) If an installment obligation described in paragraph (a) of this section is transferred within the meaning of section 691(a)(2) and paragraph (a) of § 1.691(a)–4, the entire installment obligation transferred shall be considered a right to income in respect of a decedent but the amount includible in the gross income of the transferor shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) adjusted, however, to take into account the receipt of any installment payments after the decedent's death and before such transfer. Thus, the amount includible in the gross income of the transferor shall be the fair market value of such obligation at the time of the transfer or the consideration received for the transfer of the installment obligation, whichever is greater, reduced by the basis of the obligation as described in the preceding sentence. For purposes of this paragraph, the term "transfer" in section 691(a)(2) and paragraph (a) of § 1.691(a)–4 includes the satisfaction of an installment obligation at other than face value.

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

Example. An heir of a decedent is entitled to collect an installment obligation with a face value of $100, a fair market value of $80, and a basis in the hands of the decedent of $60. If the heir collects the obligation at face value, the excess of the amount collected over the basis is considered income in respect of a decedent and includible in the gross income of the heir under section 691(a)(1). In this case, the amount includible would be $40 ($100 less $60). If the heir collects the obligation at $90, an amount other than face value, the entire obligation is considered a right to receive income in respect of a decedent but the amount ordinarily required to be included in the heir's gross income under section 691(a)(2) (namely, the consideration received in satisfaction of the installment obligation or its fair market value, whichever is greater) shall be reduced by the amount of the basis of the obligation in the hands of the decedent. In this case, the amount includible would be $30 ($90 less $60).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6808, 30 FR 3435, Mar. 16, 1965]

§ 1.691(b)–1 Allowance of deductions and credit in respect to decedents.

(a) Under section 691(b) the expenses, interest, and taxes described in sections 162, 163, 164, and 212 for which the decedent (or a prior decedent) was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid:

(1) As a deduction by the estate; or

(2) If the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires, subject to such obligation, an interest in property of the decedent (or the prior decedent).

Similar treatment is given to the foreign tax credit provided by section 33.

For the purposes of subparagraph (2) of this paragraph, the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of subparagraph (2) of this paragraph, to receive the right to any income in respect of a decedent. Thus, an heir who receives a right to income in respect of a decedent (by reason of the death of the decedent) subject to any income tax imposed by a foreign country during the decedent's life, which tax must be satisfied out of such income, is entitled to the credit provided by section 33 when he pays the tax. If a decedent who reported income by use of the cash receipts and disbursements method owned real property on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 164 that would be allowed to the decedent if, while alive, he had made such payment.

(b) The deduction for percentage depletion is allowable only to the person (described in section 691(a)(1)) who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, an heir who (by reason of the decedent's death) receives income derived from sales of units of mineral by the decedent (who reported income by use of the cash receipts and disbursements method) shall be allowed the deduction for percentage depletion, computed on the gross income from such number of units as if the heir had the same economic interest in the property as the decedent. Such heir need not also receive any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his taxable income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

§ 1.691(c)–1 Deduction for estate tax attributable to income in respect of a decedent.

(a) *In general.* A person who is required to include in gross income for any taxable year an amount of income in respect of a decedent may deduct for the same taxable year that portion of the estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount. The deduction is determined as follows:

(1) Ascertain the net value in the decedent's estate of the items which are included under section 691 in computing gross income. This is the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent (see § 1.691(a)–1 and paragraph (c) of this section) over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent (see § 1.691(b)–1). But see section 691(d) and paragraph (b) of § 1.691(d)–1 for computation of the special value of a survivor's annuity to be used in computing the net value for estate tax purposes in cases involving joint and survivor annuities.

(2) Ascertain the portion of the estate tax attributable to the inclusion in the gross estate of such net value. This is the excess of the estate tax over the estate tax computed without including such net value in the gross estate. In computing the estate tax without including such net value in the gross estate, any estate tax deduction (such as the marital deduction) which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of such net value from the gross estate. See example 2, paragraph (e) of § 1.691(d)–1.

For purposes of this section, the term *estate tax* means the tax imposed under section 2001 or 2101 (or the corresponding provisions of the Internal Revenue Code of 1939), reduced by the credits against such tax. Each person including in gross income an amount of income in respect of a decedent may deduct as his share of the portion of the estate tax (computed under subparagraph (2) of this paragraph) an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by such person in gross income (or the amount included in gross income if lower) bears to the value in the gross estate of all the items of gross income in respect of the decedent.

(b) *Prior decedent.* If a person is required to include in gross income an amount of income in respect of a prior decedent, such person may deduct for the same taxable year that portion of the estate tax imposed upon the prior decedent's estate which is attributable to the inclusion in the prior decedent's estate of the value of the right to receive such amount. This deduction is computed in the same manner as provided in paragraph (a) of this section and is in addition to the deduction for estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount.

(c) *Amounts deemed to be income in respect of a decedent.* For purposes of allowing the deduction under section 691(c), the following items are also considered to be income in respect of a decedent under section 691(a):

(1) The value for estate tax purposes of stock options in respect of which amounts are includible in gross income under section 421(b) (prior to amendment by section 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, or under section 422(c)(1), 423(c), or 424(c)(1), whichever is applicable, in the case of taxable years ending after December 31, 1963. See section 421(d)(6) (prior to amendment by sec. 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, and section 421(c)(2), in the case of taxable years ending after December 31, 1963.

(2) Amounts received by a surviving annuitant during his life expectancy period as an annuity under a joint and survivor annuity contract to the extent included in gross income under section 72. See section 691(d).

(d) *Examples.* Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. X, an attorney who kept his books by use of the cash receipts and disbursements method, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at $1,000, and to accrued bond interest, which was valued in his estate at $500. In all, $1,500 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate $150 for business expenses for which his estate was liable and $50 for taxes accrued on certain property which he owned. In all, $200 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $185,000 and, considering deductions of $15,000 and an exemption of $60,000, his taxable estate amounted to $110,000. The estate tax on this amount is $23,700 from which is subtracted a $75 credit for State death taxes leaving an estate tax liability of $23,625. In the year following the closing of X's estate, the fee in the amount of $1,200 was collected by X's son, who was the sole beneficiary of the estate. This amount was included under section 691(a)(1)(C) in the son's gross income. The son may deduct, in computing his taxable income for such year, $260 on account of the estate tax attributable to such income, computed as follows:

(1) (i) Value of income described in section 691(a)(1) included in computing gross estate	$1,500
(ii) Deductions in computing gross estate for claims representing deductions described in section 691(b)	200
(iii) Net value of items described in section 691(a)(1)	1,300
(2) (i) Estate tax	23,625
(ii) Less: Estate tax computed without including $1,300 (item (1)(iii)) in gross estate	23,235
(iii) Portion of estate tax attributable to net value of items described in section 691(a)(1)	390
(3) (i) Value in gross estate of items described in section 691(a)(1) received in taxable year (fee)	1,000
(ii) Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	1,500
(iii) Part of estate tax deductible on account of receipt of $1,200 fee (1,000/1,500 of $390)	260

Although $1,200 was later collected as the fee, only the $1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 691(c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only $500, the estate tax deductible on the receipt of such amount would be 500/1,500 of $390, or $130. With respect to taxable years ending before January 1, 1964, see paragraph (d)(3) of § 1.421–5 for a similar example involving a restricted stock option. With respect to taxable years ending after December 31, 1963, see paragraph (c)(3) of § 1.421–8 for a similar example involving a stock option subject to the provisions of part II of subchapter D.

Example 2. Assume that in example 1 the fee valued at $1,000 had been earned by prior decedent Y and had been inherited by X who died before collecting it. With regard to the son, the fee would be considered income in respect of a prior decedent. Assume further that the fee was valued at $1,000 in Y's estate, that the net value in Y's estate of items described in section 691 (a)(1) was $5,000 and that the estate tax imposed on Y's estate attributable to such net value was $550. In such case, the portion of such estate tax attributable to the fee would be 1,000/5,000 of $550, or $110. When the son collects the $1,200 fee, he will receive for the same taxable year a deduction of $110 with respect to the estate tax imposed on the estate of prior decedent Y as well as the deduction of $260 (as computed in example 1) with respect to the estate tax imposed on the estate of decedent X.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6887, 31 FR 8812, June 24, 1966]

§ 1.691(c)–2 Estates and trusts.

(a) In the case of an estate or trust, the deduction prescribed in section 691(c) is determined in the same manner as described in § 1.691(c)–1, with the following exceptions:

(1) If any amount properly paid, credited, or required to be distributed by an estate or trust to a beneficiary consists of income in respect of a decedent received by the estate or trust during the taxable year:

(i) Such income shall be excluded in determining the income in respect of the decedent with respect to which the estate or trust is entitled to a deduction under section 691(c), and

(ii) Such income shall be considered income in respect of a decedent to such beneficiary for purposes of allowing the deduction under section 691(c) to such beneficiary.

(2) For determination of the amount of income in respect of a decedent received by the beneficiary, see sections 652 and 662, and §§ 1.652(b)–2 and 1.662(b)–2. However, for this purpose, distributable net income as defined in section 643 (a) and the regulations thereunder shall be computed without taking into account the estate tax deduction provided in section 691(c) and this section. Distributable net income as modified under the preceding sentence shall be applied for other relevant purposes of subchapter J, chapter 1 of the Code, such as the deduction provided by section 651 or 661, or subpart D, part I of subchapter J, relating to excess distributions by trusts.

(3) The rule stated in subparagraph (1) of this paragraph does not apply to income in respect of a decedent which is properly allocable to corpus by the fiduciary during the taxable year but which is distributed to a beneficiary in a subsequent year. The deduction provided by section 691(c) in such a case is allowable only to the estate or trust. If any amount properly paid, credited, or required to be distributed by a trust qualifies as a distribution under section 666, the fact that a portion thereof constitutes income in respect of a decedent shall be disregarded for the purposes of determining the deduction of the trust and of the beneficiaries under section 691(c) since the deduction for estate taxes was taken into consideration in computing the undistributed net income of the trust for the preceding taxable year.

(b) This section shall apply only to amounts properly paid, credited, or required to be distributed in taxable years of an estate or trust beginning after December 31, 1953, and ending after August 16, 1954, except as otherwise provided in paragraph (c) of this section.

(c) In the case of an estate or trust heretofore taxable under the provisions of the Internal Revenue Code of 1939, amounts paid, credited, or to be distributed during its first taxable year subject to the Internal Revenue Code of 1954 which would have been treated as paid, credited, or to be distributed on the last day of the preceding taxable year if the Internal Revenue Code of 1939 were still applicable shall not be subject to the provisions of section 691(c)(1)(B) or this section. See section 683 and the regulations thereunder.

(d) The provisions of this section may be illustrated by the following example, in which it is assumed that the estate and the beneficiary make their returns on the calendar year basis:

Example. (1) The fiduciary of an estate receives taxable interest of $5,500 and income in respect of a decedent of $4,500 during the taxable year. Neither the will of the decedent nor local law requires the allocation to corpus of income in respect of a decedent. The estate tax attributable to the income in respect of a decedent is $1,500. In his discretion, the fiduciary distributes $2,000 (falling within sections 661(a) and 662(a)) to a beneficiary during that year. On these facts the fiduciary and beneficiary are respectively entitled to estate tax deductions of $1,200 and $300, computed as follows:

(2) Distributable net income computed under section 643(a) without regard to the estate tax deduction under section 691(c) is $10,000, computed as follows:

Taxable interest	$5,500
Income in respect of a decedent	4,500
Total	10,000

(3) Inasmuch as the distributable net income of $10,000 exceeds the amount of $2,000 distributed to the beneficiary, the deduction allowable to the estate under section 661(a) and the amount taxable to the beneficiary under section 662(a) is $2,000.

(4) The character of the amounts distributed to the beneficiary under section 662 (b) is shown in the following table:

	Taxable interest	Income in respect of a decedent	Total
Distributable net income	$5,500	$4,500	$10,000
Amount deemed distributed under section 662(b)	1,100	900	2,000

(5) Accordingly, the beneficiary will be entitled to an estate tax deduction of $300 (900/4,500×$1,500) and the estate will be entitled to an estate tax deduction of $1,200 (3,600/4,500×$1,500).

(6) The taxable income of the estate is $6,200, computed as follows:

Gross income		$10,000
Less:		
Distributions to the beneficiary	$2,000	
Estate tax deduction under section 691(c)	1,200	
Personal exemption	600	
		3,800
Taxable income		6,200

§ 1.691(d)–1 Amounts received by surviving annuitant under joint and survivor annuity contract.

(a) *In general.* Under section 691(d), annuity payments received by a surviving annuitant under a joint and survivor annuity contract (to the extent indicated in paragraph (b) of this section) are treated as income in respect of a decedent under section 691(a) for the purpose of allowing the deduction for estate tax provided for in section 691(c)(1)(A). This section applies only if the deceased annuitant died after December 31, 1953, and after the annuity starting date as defined in section 72(c)(4).

(b) *Special value for surviving annuitant's payments.* Section 691(d) provides a special value for the surviving annuitant's payments to determine the amount of the estate tax deduction provided for in section 691(c)(1)(A). This special value is determined by multiplying:

(1) The excess of the value of the annuity at the date of death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during his life expectancy period (see paragraph (d)(1)(i) of this section)

by

(2) A fraction consisting of the value of the annuity for estate tax purposes over the value of the annuity at the date of death of the deceased annuitant.

This special value is used for the purpose of determining the net value for estate tax purposes (see section 691(c)(2)(B) and paragraph (a)(1) of § 1.691(c)–1) and for the purpose of determining the portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)–1).

(c) *Amount of deduction.* The portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)–1) is allowable as a deduction to the surviving annuitant over his life expectancy period. If the surviving annuitant continues to receive annuity payments beyond this period, there is no further deduction under section 691(d). If the surviving annuitant dies before expiration of such period, there is no compensating adjustment for the unused deduction.

(d) *Definitions.* (1) For purposes of section 691(d) and this section:

(i) The term *life expectancy period* means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant.

(ii) The life expectancy of the surviving annuitant shall be determined as of the date of death of the deceased annuitant, with reference to actuarial Table I set forth in § 1.72–9 (but without making any adjustment under paragraph (a)(2) of § 1.72–5).

(iii) The value of the annuity at the date of death of the deceased annuitant shall be the entire value of the survivor's annuity determined by reference to the principles set forth in section 2031 and the regulations thereunder, relating to the valuation of annuities for estate tax purposes.

(iv) The value of the annuity for estate tax purposes shall be that portion of the value determined under subdivision (iii) of this subparagraph which was includible in the deceased annuitant's gross estate.

(2) The determination of the ''life expectancy period'' of the survivor for purposes of section 691(d) may be illustrated by the following example:

Example. H and W file their income tax returns on the calendar year basis. H dies on July 15, 1955, on which date W is 70 years of age. On August 1, 1955, W receives a monthly payment under a joint and survivor annuity contract. W's life expectancy determined as of the date of H's death is 15 years as determined from Table I in § 1.72–9; thus her life expectancy ends on July 14, 1970. Under the provisions of section 691(d), her life expectancy period begins as of July 1, 1955, and ends as of December 31, 1970, thus giving her a life expectancy period of 15 1/2 years.

(e) *Examples.* The application of section 691(d) and this section may be illustrated by the following examples:

Example 1. (1) H and W, husband and wife, purchased a joint and survivor annuity contract for $203,800 providing for monthly payments of $1,000 starting January 28, 1954, and continuing for their joint lives and for the remaining life of the survivor. H contributed $152,850 and W contributed $50,950 to the cost of the annuity. As of the annuity starting date, January 1, 1954, H's age at his nearest birthday was 70 and W's age at her nearest birthday was 67. H dies on January 1, 1957, and beginning on January 28, 1957, W receives her monthly payments of $1,000. The value of the annuity at the date of H's death is $159,000 (see paragraph (d)(1)(iii) of this section), and the value of the annuity for estate tax purposes (see paragraph (d)(1)(iv) of this section) is $119,250 (152,850/203,800 of $159,000). As of the date of H's death, W's age is 70 and her life expectancy period is 15 years (see paragraph (d) of this section for method of computation). Both H and W reported income by use of the cash receipts and disbursements method and filed income tax returns on the calendar year basis.

(2) The following computations illustrate the application of section 72 in determining the excludable portions of the annuity payments to W during her life expectancy period:

Amount of annuity payments per year (12×$1,000)	$12,000
Life expectancy of H and W as of the annuity starting date (see section 72(c)(3)(A) and Table II of § 1.72–9 (male, age 70; female, age 67))	19.7
Expected return as of the annuity starting date, January 1, 1954 ($12,000×19.7 as determined under section 72(c)(3)(A) and paragraph (b) of § 1.72–5)	$236,400
Investment in the contract as of the annuity starting date, Jan. 1, 1954 (see section 72(c)(1) and paragraph (a) of § 1.72–6)	$203,800
Exclusion ratio (203,800/236,400 as determined under section 72(b) and § 1.72–4) (percent)	86.2
Exclusion per year under section 72 ($12,000×86.2 percent)	$10,344
Excludable during W's life expectancy period ($10,344×15)	$155,160

(3) For the purpose of computing the deduction for estate tax under section 691(c), the value for estate tax purposes of the amounts includible in W's gross income and considered income in respect of a decedent by virtue of section 691(d)(1) is $2,880. This amount is arrived at in accordance with the formula contained in section 691(d)(2), as follows:

Value of annuity at the date of H's death	$159,000
Total amount excludable from W's gross income under section 72 during W's life expectancy period (see subparagraph (2) of this example)	$155,160
Excess	$3,840
Ratio which value of annuity for estate tax purposes bears to value of annuity at date of H's death (119,250/159,000) (percent)	75
Value for estate tax purposes (75 percent of $3,840)	$2,880

This amount ($2,880) is included in the items of income under section 691(a)(1) for the purpose of determining the estate tax attributable to each item under section 691(c)(1)(A). The estate tax determined to be attributable to the item of $2,880 is then allowed as a deduction to W over her 15-year life expectancy period (see example 2 of this paragraph).

Example 2. Assume, in addition to the facts contained in example 1 of this paragraph, that H was an attorney and was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued at $1,000, and to accrued bond interest, which was valued at $500. Taking into consideration the annuity payments of example 1, valued at $2,880, a total of $4,380 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate $280 for business expenses for which his estate was liable and $100 for taxes accrued on certain property which he owned. In all, $380 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $404,250 and considering deductions of $15,000, a marital deduction of $119,250 (assuming the annuity to be the only qualifying gift) and an exemption of $60,000, his taxable estate amounted to $210,000. The estate tax on this amount is $53,700 from which is subtracted a $175 credit for State death taxes, leaving an estate tax liability of $53,525. W may deduct, in computing her taxable income during each year of her 15-year life expectancy period, $14.73 on account of the estate tax attributable to the value for estate tax purposes of that portion of the annuity payments considered income in respect of a decedent, computed as follows:

(1)(i) Value of income described in section 691(a)(1) included in computing gross estate	$4,380.00
(ii) Deductions in computing gross estate for claims representing deductions described in section 691(b)	380.00
(iii) Net value of items described in section 691(a) (1)	4,000.00
(2)(i) Estate tax	53,525.00
(ii) Less: estate tax computed without including $4,000 (item (1) (iii)) in gross estate and by reducing marital deduction by $2,880 (portion of item (1)(iii) allowed as a marital deduction)	53,189.00
(iii) Portion of estate tax attributable to net value of income items	336.00
(3)(i) Value in gross estate of income attributable to annuity payments	2,880.00
(ii) Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	4,380.00
(iii) Part of estate tax attributable to annuity income (2,880/4,380 of $336)	220.93
(iv) Deduction each year on account of estate tax attributable to annuity income ($220.93÷15 (life expectancy period))	14.73

§ 1.691(e)–1 Installment obligations transmitted at death when prior law applied.

(a) *In general*—(1) *Application of prior law.* Under section 44(d) of the Internal Revenue Code of 1939 and corresponding provisions of prior law, gains and losses on account of the transmission of installment obligations at the death of a holder of such obligations were required to be reported in the return of the decedent for the year of his death. However, an exception to this rule was provided if there was filed with the Commissioner a bond assuring the return as income of any payment in satisfaction of these obligations in the same proportion as would have been returnable as income by the decedent had he lived and received such payments. Obligations in respect of which such bond was filed are referred to in this section as ''obligations assured by bond''.

(2) *Application of present law.* Section 691(a)(4) of the Internal Revenue Code of 1954 (effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954) in effect makes the exception which under prior law applied to obligations assured by bond the general rule for obligations transmitted at death, but contains no requirement for a bond. Section 691(e)(1) provides that if the holder of the installment obligation makes a proper election, the provisions of section 691(a)(4) shall apply in the case of obligations assured by bond. Section 691(e)(1) further provides that the estate tax deduction provided by section 691(c)(1) is not allowable for any amount included in gross income by reason of filing such an election.

(b) *Manner and scope of election*—(1) *In general.* The election to have obligations assured by bond treated as obligations to which section 691(a)(4) applies shall be made by the filing of a statement with respect to each bond to be released, containing the following information:

(i) The name and address of the decedent from whom the obligations assured by bond were transmitted, the date of his death, and the internal revenue district in which the last income tax return of the decedent was filed.

(ii) A schedule of all obligations assured by the bond on which is listed—

(a) The name and address of the obligors, face amount, date of maturity, and manner of payment of each obligation,

(b) The name, identifying number (provided under section 6109 and the regulations thereunder), and address of each person holding the obligations, and

(c) The name, identifying number, and address, of each person who at the time of the election possesses an interest in each obligation, and a description of such interest.

(iii) The total amount of income in respect of the obligations which would have been reportable as income by the decedent if he had lived and received such payment.

(iv) The amount of income referred to in subdivision (iii) of this subparagraph which has previously been included in gross income.

(v) An unqualified statement, signed by all persons holding the obligations, that they elect to have the provisions of section 691(a)(4) apply to such obligations and that such election shall be binding upon them, all current beneficiaries, and any person to whom the obligations may be transmitted by gift, bequest, or inheritance.

(vi) A declaration that the election is made under the penalties of perjury.

(2) *Filing of statement.* The statement with respect to each bond to be released shall be filed in duplicate with the district director of internal revenue for the district in which the bond is maintained. The statement shall be filed not later than the time prescribed for filing the return for the first taxable year (including any extension of time for such filing) to which the election applies.

(3) *Effect of election.* The election referred to in subparagraph (1) of this paragraph shall be irrevocable. Once an election is made with respect to an obligation assured by bond, it shall apply to all payments made in satisfaction of such obligation which were received during the first taxable year to which the election applies and to all such payments received during each taxable year thereafter, whether the recipient is the person who made the election, a current beneficiary, or a person to whom the obligation may be transmitted by gift, bequest, or inheritance. Therefore, all payments received to which the election applies shall be treated as payments made on installment obligations to which section 691(a)(4) applies. However, the estate tax deduction provided by section 691(c) is not allowable for any such payment. The application of this subparagraph may be illustrated by the following example:

Example. A, the holder of an installment obligation, died in 1952. The installment obligation was transmitted at A's death to B who filed a bond on Form 1132 pursuant to paragraph (c) of §39.44–5 of Regulations 118 (26 CFR part 39, 1939 ed.) for the necessary amount. On January 1, 1965, B, a calendar year taxpayer, filed an election under section 691(e) to treat the obligation assured by bond as an obligation to which section 691(a)(4) applies, and B's bond was released for 1964 and subsequent taxable years. B died on June 1, 1965, and the obligation was bequeathed to C. On January 1, 1966, C received an installment payment on the obligation which had been assured by the bond. Because B filed an election with respect to the obligation assured by bond, C is required to treat the proper proportion of the January 1, 1966, payment and all subsequent payments made in satisfaction of this obligation as income in respect of a decedent. However, no estate tax deduction is allowable to C under section 691(c)(1) for any estate tax attributable to the inclusion of the value of such obligation in the estate of either A or B.

(c) *Release of bond.* If an election according to the provisions of paragraph (b) of this section is filed, the liability under any bond filed under section 44(d) of the 1939 Code (or the corresponding provisions of prior law) shall be released with respect to each taxable year to which such election applies. However, the liability under any such bond for an earlier taxable year to which the election does not apply shall not be released until the district director of internal revenue for the district in which the bond is maintained is assured that the proper portion of each installment payment received in such taxable year has been reported and the tax thereon paid.

[T.D. 6808, 30 FR 3436, Mar. 16, 1965]

§ 1.691(f)–1 Cross reference.

See section 753 and the regulations thereunder for application of section 691 to income in respect of a deceased partner.

[T.D. 6808, 30 FR 3436, Mar. 16, 1965]

§ 1.692–1 Abatement of income taxes of certain members of the Armed Forces of the United States upon death.

(a)(1) This section applies if:

(i) An individual dies while in active service as a member of the Armed Forces of the United States, and

(ii) His death occurs while he is serving in a combat zone (as determined under section 112), or at any place as a result of wounds, disease, or injury incurred while he was serving in a combat zone.

(2) If an individuals dies as described in paragraph (a)(1), the following liabilities for tax, under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, are canceled:

(i) The libaility of the deceased individual, for the last taxable year, ending on the date of his death, and for any prior taxable year ending on or after the first day he served in a combat zone in active service as a member of the U.S. Armed Forces after June 24, 1950, and

(ii) The liability of any other person to the extent the liability is attributable to an amount received after the individual's death (including income in respect of a decedent under section 691) which would have been includible in the individual's gross income for his taxable year in which the date of his death falls (determined as if he had survived).

If the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment will be abated. If the amount of the tax is collected (regardless of the date of collection), the amount so collected will be credited or refunded as an overpayment.

(3) If an individual dies as described in paragraph (a)(1), there will not be assessed any amount of tax of the indvidual for taxable years preceding the years specified in paragraph (a)(2), under subtitle A of the Internal Revenue Code of 1954, chapter 1 of the Internal Revenue Code of 1939, or corresponding provisions of prior revenue laws, remaining unpaid as of the date of death. If any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, the assessments will be abated. If the amount of any such unpaid tax is collected after the date of death, the amount so collected will be credited or refunded as an overpayment.

(4) As to what constitutes active service as a member of the Armed Forces, service in a combat zone, and wounds, disease, or injury incurred while serving in a combat zone, see section 112. As to who are members of the Armed Forces, see section 7701(a)(15). As to the period of time within which any claim for refund must be filed, see sections 6511(a) and 7508(a)(1)(E).

(b) If such an individual and his spouse have for any such year filed a joint return, the tax abated, credited, or refunded pursuant to the provisions of section 692 for such year shall be an amount equal to that portion of the joint tax liability which is the same percentage of such joint tax liability as a tax computed upon the separate income of such individual is of the sum of the taxes computed upon the separate income of such individual and his spouse, but with respect to taxable years ending before June 24, 1950, and with respect to taxable years ending before the first day such individual served in a combat zone, as determined under section 112, the amount so abated, credited, or refunded shall not exceed the amount unpaid at the date of death. For such purpose, the separate tax of each spouse:

(1) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, shall be the tax computed under subtitle A of the Internal Revenue Code of 1954 before the application of sections 31, 32, 6401(b), and 6402, but after the application of section 33, as if such spouse were required to make a separate income tax return; and

(2) For taxable years beginning before January 1, 1954, and for taxable years beginning after December 31, 1953, and ending before August 17, 1954, shall be the tax computed under chapter 1 of the Internal Revenue Code of 1939 before the application of sections 32, 35, and 322(a), but after the application of section 31, as if such spouse were required to make a separate income tax return.

(c) If such an individual and his spouse filed a joint declaration of estimated tax for the taxable year ending with the date of his death, the estimated tax paid pursuant to such declaration may be treated as the estimated tax of either such individual or his spouse, or may be divided between them, in such manner as his legal representative and such spouse may agree. Should they agree to treat such estimated tax, or any portion thereof, as the estimated tax of such individual, the estimated tax so paid shall be credited or refunded as an overpayment for the taxable year ending with the date of his death.

(d) For the purpose of determining the tax which is unpaid at the date of death, amounts deducted and withheld under chapter 24, subtitle C of the Internal Revenue Code of 1954, or under subchapter D, chapter 9 of the Internal Revenue Code of 1939 (relating to income tax withheld at source on wages), constitute payment of tax imposed under subtitle A of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939, as the case may be.

(e) This section shall have no application whatsoever with respect to the liability of an individual as a transferee of property of a taxpayer where such liability relates to the tax imposed upon the taxpayer by subtitle A of the Internal Revenue Code of 1954 or by chapter 1 of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7543, 43 FR 19392, May 5, 1978]

PARTNERS AND PARTNERSHIPS

DETERMINATION OF TAX LIABILITY

§ 1.701–1 Partners, not partnership, subject to tax.

Partners are liable for income tax only in their separate capacities. Partnerships as such are not subject to the income tax imposed by subtitle A but are required to make returns of income under the provisions of section 6031 and the regulations thereunder. For definition of the terms ''partner'' and ''partnership'', see sections 761 and 7701(a)(2), and the regulations thereunder. For provisions relating to the election of certain partnerships to be taxed as domestic corporations, see section 1361 and the regulations thereunder.

§ 1.701–2 Anti-abuse rule.

(a) *Intent of subchapter K.* Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements—

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, *proper reflection of income*). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) *Example 6* of this section (relating to the value-equals-basis rule in § 1.704–1(b)(2)(iii)(*c*)), paragraph (d) *Example 9* of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) *Examples 10 and 11* of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§ 1.704–3(e)(1) and 1.752–2(e)(4) (providing certain de minimis exceptions).

(b) *Application of subchapter K rules.* The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (*intent of* *subchapter K*). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—

(1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;

(2) One or more of the purported partners of the partnership should not be treated as a partner;

(3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;

(4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or

(5) The claimed tax treatment should otherwise be adjusted or modified.

(c) *Facts and circumstances analysis; factors.* Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704–1 and 1.704–2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to

one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

(d) *Examples.* The following examples illustrate the principles of paragraphs (a), (b), and (c) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. Choice of entity; avoidance of entity-level tax; use of partnership consistent with the intent of subchapter K. (i) A and B form limited partnership PRS to conduct a bona fide business. A, the corporate general partner, has a 1% partnership interest. B, the individual limited partner, has a 99% interest. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. A and B chose limited partnership form as a means to provide B with limited liability without subjecting the income from the business operations to an entity-level tax.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. Although B has retained, indirectly, substantially all of the benefits and burdens of ownership of the money or property B contributed to PRS (see paragraph (c)(6) of this section), the decision to organize and conduct business through PRS under these circumstances is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 2. Choice of entity; avoidance of subchapter S shareholder requirements; use of partnership consistent with the intent of subchapter K. (i) A and B form partnership PRS to conduct a bona fide business. A is a corporation that has elected to be treated as an S corporation under subchapter S. B is a nonresident alien. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. Because section 1361(b) prohibits B from being a shareholder in A, A and B chose partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of subchapter S treatment for A and its shareholders.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the partnership transaction should not be respected because it does not reflect its substance (inasmuch as application of the substance over form doctrine arguably could result in B being treated as a shareholder of A, thereby invalidating A's subchapter S election), the facts indicate otherwise. The shareholders of A are subject to tax on their pro rata shares of A's income (see section 1361 *et seq.*), and B is subject to tax on B's distributive share of partnership income (see sections 871 and 875). Thus, the form in which this arrangement is cast accurately reflects its substance as a separate partnership and S corporation. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 3. Choice of entity; avoidance of more restrictive foreign tax credit limitation; use of partnership consistent with the intent of subchapter K. (i) X, a domestic corporation, and Y, a foreign corporation, form partnership PRS under the laws of foreign Country A to conduct a bona fide joint business. X and Y each owns a 50% interest in PRS. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. PRS pays income taxes to Country A. X and Y chose partnership form to enable X to qualify for a direct foreign tax credit under section 901, with look-through treatment under § 1.904–5(h)(1). Conversely, if PRS were a foreign corporation for U.S. tax purposes, X would be entitled only to indirect foreign tax credits under section 902 with respect to dividend distributions from PRS. The look-through rules, however, would not apply, and pursuant to section 904(d)(1)(E) and § 1.904–4(g), the dividends and associated taxes would be subject to a separate foreign tax credit limitation for dividends from PRS, a noncontrolled section 902 corporation.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS in order to take advantage of the look-through rules for foreign tax credit purposes, thereby maximizing X's use of its proper share of foreign taxes paid by PRS, is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 4. Choice of entity; avoidance of gain recognition under sections 351(e) and 357(c); use of partnership consistent with the intent of subchapter K. (i) X, ABC, and DEF form limited partnership PRS to conduct a bona fide real estate management business. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. X, the general partner, is a newly formed corporation that elects to be treated as a real estate investment trust as defined in section 856. X offers its stock to the public and contributes substantially all of the proceeds from the public offering to PRS. ABC and DEF, the limited partners, are existing partnerships with substantial real estate holdings. ABC and DEF contribute all of their real property assets to PRS, subject to liabilities that exceed their respective aggregate bases in the real property contributed, and terminate under section 708(b)(1)(A). In addition, some of the former partners of ABC and DEF each have the right, beginning two years after the formation of PRS, to require the redemption of their limited partnership interests in PRS in exchange for cash or X stock (at X's option) equal to the fair market value of their respective interests in PRS at the time of the redemption. These partners are not compelled, as a legal or practical matter, to exercise their exchange rights at any time. X, ABC, and DEF chose to form a partnership rather than have ABC and DEF invest directly in X to allow ABC and DEF to avoid recognition of gain under sections 351(e) and 357(c). Because PRS would not be treated as an investment company within the meaning of section 351(e) if PRS were incorporated (so long as it did not elect under section 856), section 721(a) applies to the contribution of the real property to PRS. See section 721(b).

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS, thereby avoiding the tax consequences that would have resulted from contributing the existing partnerships' real estate assets to X (by applying the rules of sections 721, 731, and 752 in lieu of the rules of sections 351(e) and 357(c)), is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the transaction should not be respected because it does not reflect its substance (inasmuch as the present value of the partners' aggregate federal tax liability is substantially less than would be the case if the transaction were integrated and treated as a contribution of the encumbered assets by ABC and DEF directly to X, see paragraph (c)(2) of this section), the facts indicate otherwise. For example, the right of some of the former ABC and DEF partners after two years to exchange their PRS interests for cash or X stock (at X's option) equal to the fair market value of their PRS interest at that time would not require that right to be considered as exercised prior to its actual exercise. Moreover, X may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes. Thus, although it may be likely that some or all of the partners with the right to do so will, at some point, exercise their exchange rights, and thereby receive either cash or X stock, the form of the transaction as a separate partnership and real estate investment trust is respected under substance over form principles (see paragraph (a)(2) of this section). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 5. Special allocations; dividends received deductions; use of partnership consistent with the intent of subchapter K. (i) Corporations X and Y contribute equal amounts to PRS, a bona fide partnership formed to make joint investments. PRS pays $100x for a share of common stock of Z, an unrelated corporation, which has historically paid an annual dividend of $6x. PRS specially allocates the dividend income on the Z stock to X to the extent of the London Inter-Bank Offered Rate (LIBOR) on the record date, applied to X's contribution of $50x, and allocates the remainder of the dividend income to Y. All other items of partnership income and loss are allocated equally between X and Y. The allocations under the partnership agreement have substantial economic effect within the meaning of § 1.704–1(b)(2). In addition to avoiding an entity-level tax, a principal purpose for the formation of the partnership was to invest in the Z common stock and to allocate the dividend income from the stock to provide X with a floating-rate return based on LIBOR, while permitting X and Y to claim the dividends received deduction under section 243 on the dividends allocated to each of them.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Section 704(b) and §1.704–1(b)(2) permit income realized by the partnership to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Section 704(e)(2) is not applicable to the facts of this example (otherwise, the allocations would be required to be proportionate to the partners' ownership of contributed capital). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 6. Special allocations; nonrecourse financing; low-income housing credit; use of partnership consistent with the intent of subchapter K. (i) A and B, high-bracket taxpayers, and X, a corporation with net operating loss carryforwards, form general partnership PRS to own and operate a building that qualifies for the low-income housing credit provided by section 42. The project is financed with both cash contributions from the partners and nonrecourse indebtedness. The partnership agreement provides for special allocations of income and deductions, including the allocation of all depreciation deductions attributable to the building to A and B equally in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the building. The section 42 credits are allocated to A and B in accordance with the allocation of depreciation deductions. PRS's allocations comply with all applicable regulations, including the requirements of §§1.704–1(b)(2)(ii) (pertaining to economic effect) and 1.704–2(e) (requirements for allocations of nonrecourse deductions). The nonrecourse indebtedness is validly allocated to the partners under the rules of §1.752–3, thereby increasing the basis of the partners' respective partnership interests. The basis increase created by the nonrecourse indebtedness enables A and B to deduct their distributive share of losses from the partnership (subject to all other applicable limitations under the Internal Revenue Code) against their nonpartnership income and to apply the credits against their tax liability.

(ii) At a time when the depreciation deductions attributable to the building are not treated as nonrecourse deductions under §1.704–2(c) (because there is no net increase in partnership minimum gain during the year), the special allocation of depreciation deductions to A and B has substantial economic effect because of the value-equals-basis safe harbor contained in §1.704–1(b)(2)(iii)(*c*) and the fact that A and B would bear the economic burden of any decline in the value of the building (to the extent of the partnership's investment in the building), notwithstanding that A and B believe it is unlikely that the building will decline in value (and, accordingly, they anticipate significant timing benefits through the special allocation). Moreover, in later years, when the depreciation deductions attributable to the building are treated as nonrecourse deductions under §1.704–2(c), the special allocation of depreciation deductions to A and B is considered to be consistent with the partners' interests in the partnership under §1.704–2(e).

(iii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a) (1), (2), and (3) of this section have been satisfied. Section 704(b), §1.704–1(b)(2), and §1.704–2(e) allow partnership items of income, gain, loss, deduction, and credit to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Moreover, the application of the value-equals-basis safe harbor and the provisions of §1.704–2(e) with respect to the allocations to A and B, and the tax results of the application of those provisions, taking into account all the facts and circumstances, are clearly contemplated. Accordingly, even if the allocations would not otherwise be considered to satisfy the proper reflection of income standard in paragraph (a)(3) of this section, that requirement will be treated as satisfied under these facts. Thus, even though the partners' aggregate federal tax liability may be substantially less than had the partners owned the partnership's assets directly (due to X's inability to use its allocable share of the partnership's losses and credits) (see paragraph (c)(1) of this section), the transaction is not inconsistent with the intent of subchapter K. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 7. Partner with nominal interest; temporary partner; use of partnership not consistent with the intent of subchapter K. (i) Pursuant to a plan a principal purpose of which is to generate artificial losses and thereby shelter from federal taxation a substantial amount of income, X (a foreign corporation), Y (a domestic corporation), and Z (a promoter) form partnership PRS by contributing $9,000*x*, $990*x*, and $10*x*, respectively, for proportionate interests (90.0%, 9.9%, and 0.1%, respectively) in the capital and profits of PRS. PRS purchases offshore equipment for $10,000*x* and validly leases the equipment offshore for a term representing most of its projected useful life. Shortly thereafter, PRS sells its rights to receive income under the lease to a third party for $9,000*x*, and allocates the resulting $9,000*x* of income $8,100*x* to X, $891*x* to Y, and $9*x* to Z. PRS thereafter makes a distribution of $9,000*x* to X in complete liquidation of its interest. Under § 1.704–1(b)(2)(iv)(*f*), PRS restates the partners' capital accounts immediately before making the liquidating distribution to X to reflect its assets consisting of the offshore equipment worth $1,000*x* and $9,000*x* in cash. Thus, because the capital accounts immediately before the distribution reflect assets of $19,000*x* (that is, the initial capital contributions of $10,000*x* plus the $9,000*x* of income realized from the sale of the lease), PRS allocates a $9,000*x* book loss among the partners (for capital account purposes only), resulting in restated capital accounts for X, Y, and Z of $9,000*x*, $990*x*, and $10*x*, respectively. Thereafter, PRS purchases real property by borrowing the $8,000*x* purchase price on a recourse basis, which increases Y's and Z's bases in their respective partnership interests from $1,881*x* and $19*x*, to $9,801*x* and $99*x*, respectively (reflecting Y's and Z's adjusted interests in the partnership of 99% and 1%, respectively). PRS subsequently sells the offshore equipment, subject to the lease, for $1,000*x* and allocates the $9,000*x* tax loss $8,910*x* to Y and $90*x* to Z. Y's and Z's bases in their partnership interests are therefore reduced to $891*x* and $9*x*, respectively.

(ii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), (3), and (5) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section) and does not properly reflect the income of Y (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or the validity of the allocations under § 1.704–1(b)(2) (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 8. Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K. (i) A owns land with a basis of $100*x* and a fair market value of $60*x*. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. To effect this plan, A, C (A's brother), and W (C's wife) form partnership PRS, to which A contributes the land, and C and W each contribute $30*x*. All partnership items are shared in proportion to the partners' respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership's assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset held by PRS. Under section 732(b), A's basis in the asset distributed equals $100*x*, A's basis in A's partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a $40*x* loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains $100*x*. At the end of year 3, pursuant to the lease option, PRS sells the land to B for $60*x* (its fair market value). Thus, PRS recognizes a $40*x* loss on the sale, which is allocated equally between C and W. C's and W's bases in their partnership interests are reduced to $10*x* each pursuant to section 705. Their respective interests are worth $30*x* each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize $20*x* of gain. However, PRS's continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A's built-in loss in the land prior to its contribution to PRS.

(iii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 9. Absence of section 754 election; use of partnership consistent with the intent of subchapter K. (i) PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of $100*x*, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually agreed to by A and the managing general partner, P. P and A agree to distribute to A $100*x* worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of $20*x*. Upon distribution, A's aggregate basis in the securities is $100*x* under section 732(b). PRS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the $80*x* of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly recognized that if the section 754 election were not made, basis distortions may result. Taking into account all the facts and circumstances of the transaction, the electivity of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 10. Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K. (i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of $100*x*, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of $60*x* and a basis to PRS of $40*x*, and related equipment with two years of cost recovery remaining and a value and basis to PRS of $40*x*. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732 (b) and (c), A's $100*x* basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or $50*x* to the nondepreciable asset and $50*x* to the equipment. Thus, A will have a $10*x* built-in gain in the nondepreciable asset ($60*x* value less $50*x* basis) and a $10*x* built-in loss in the equipment ($50*x* basis less $40*x* value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732 (b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 11. Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K. (i) Partnership PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS, which has a value of $95*x* and a basis of $5*x*. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes $100*x* to PRS for an interest therein. Subsequently (at a time when the value of the partnership's assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of $5*x*. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732 (b) and (c), X's \$100*x* basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or \$50*x* each. Thereafter, X plans to sell the second asset for its value of \$5*x*, recognizing a loss of \$45*x*. In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732 (b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.

(ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

(e) *Abuse of entity treatment*—(1) *General rule.* The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.

(2) *Clearly contemplated entity treatment.* Paragraph (e)(1) of this section does not apply to the extent that—

(i) A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and

(ii) That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

(f) *Examples.* The following examples illustrate the principles of paragraph (e) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. Aggregate treatment of partnership appropriate to carry out purpose of section 163(e)(5). (i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS issues certain high yield discount obligations to an unrelated third party. Section 163(e)(5) defers (and in certain circumstances disallows) the interest deductions on this type of obligation if issued by a corporation. PRS, X, and Y take the position that, because PRS is a partnership and not a corporation, section 163(e)(5) is not applicable.

(ii) Section 163(e)(5) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 163(e)(5) is to limit corporate-level interest deductions on certain obligations. The treatment of PRS as an entity could result in a partnership with corporate partners issuing those obligations and thereby circumventing the purpose of section 163(e)(5), because the corporate partner would deduct its distributive share of the interest on obligations that would have been deferred until paid or disallowed had the corporation issued its share of the obligation directly. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 163(e)(5) (regardless of whether any party had a tax avoidance purpose in having PRS issue the obligation). Each partner of PRS will therefore be treated as issuing its share of the obligations for purposes of determining the deductibility of its distributive share of any interest on the obligations. See also section 163(i)(5)(B).

Example 2. Aggregate treatment of partnership appropriate to carry out purpose of section 1059. (i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS purchases 50 shares of Corporation Z common stock. Six months later, Corporation Z announces an extraordinary dividend (within the meaning of section 1059). Section 1059(a) generally provides that if any corporation receives an extraordinary dividend with respect to any share of stock and the corporation has not held the stock for more than two years before the dividend announcement date, the basis in the stock held by the corporation is reduced by the nontaxed portion of the dividend. PRS, X, and Y take the position that section 1059(a) is not applicable because PRS is a partnership and not a corporation.

(ii) Section 1059(a) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 1059(a) is to limit the benefits of the dividends received deduction with respect to extraordinary dividends. The treatment of PRS as an entity could result in corporate partners in the partnership receiving dividends through partnerships in circumvention of the intent of section 1059. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 1059 (regardless of whether any party had a tax avoidance purpose in acquiring the Z stock through PRS). Each partner of PRS will therefore be treated as owning its share of the stock. Accordingly, PRS must make appropriate adjustments to the basis of the Corporation Z stock, and the partners must also make adjustments to the basis in their respective interests in PRS under section 705(a)(2)(B). See also section 1059(g)(1).

Example 3. Prescribed entity treatment of partnership; determination of CFC status clearly contemplated. (i) X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign Country A. They form PRS, a bona fide domestic general partnership in which X owns a 40% interest and Y owns a 60% interest. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. PRS holds 100% of the voting stock of Z, a Country A entity that is classified as an association taxable as a corporation for federal tax purposes under § 301.7701–2. Z conducts its business operations in Country A. By investing in Z through a domestic partnership, X seeks to obtain the benefit of the look-through rules of section 904(d)(3) and, as a result, maximize its ability to claim credits for its proper share of Country A taxes expected to be incurred by Z.

(ii) Pursuant to sections 957(c) and 7701(a)(30), PRS is a United States person. Therefore, because it owns 10% or more of the voting stock of Z, PRS satisfies the definition of a U.S. shareholder under section 951(b). Under section 957(a), Z is a controlled foreign corporation (CFC) because more than 50% of the voting power or value of its stock is owned by PRS. Consequently, under section 904(d)(3), X qualifies for look-through treatment in computing its credit for foreign taxes paid or accrued by Z. In contrast, if X and Y owned their interests in Z directly, Z would not be a CFC because only 40% of its stock would be owned by U.S. shareholders. X's credit for foreign taxes paid or accrued by Z in that case would be subject to a separate foreign tax credit limitation for dividends from Z, a noncontrolled section 902 corporation. See section 904(d)(1)(E) and § 1.904–4(g).

(iii) Sections 957(c) and 7701(a)(30) prescribe the treatment of a domestic partnership as an entity for purposes of defining a U.S. shareholder, and thus, for purposes of determining whether a foreign corporation is a CFC. The CFC rules prevent the deferral by U.S. shareholders of U.S. taxation of certain earnings of the CFC and reduce disparities that otherwise might occur between the amount of income subject to a particular foreign tax credit limitation when a taxpayer earns income abroad directly rather than indirectly through a CFC. The application of the look-through rules for foreign tax credit purposes is appropriately tied to CFC status. See sections 904(d)(2)(E) and 904(d)(3). This analysis confirms that Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, under paragraph (e) of this section, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of determining X's foreign tax credit limitation.

(g) *Effective date.* Paragraphs (a), (b), (c), and (d) of this section are effective for all transactions involving a partnership that occur on or after May 12, 1994. Paragraphs (e) and (f) of this section are effective for all transactions involving a partnership that occur on or after December 29, 1994.

(h) *Scope and application.* This section applies solely with respect to taxes under subtitle A of the Internal Revenue Code, and for purposes of this section, any reference to a federal tax is limited to any tax imposed under subtitle A of the Internal Revenue Code.

(i) *Application of nonstatutory principles and other statutory authorities.* The Commissioner can continue to assert and to rely upon applicable nonstatutory principles and other statutory and regulatory authorities to challenge transactions. This section does not limit the applicability of those principles and authorities.

[T.D. 8588, 60 FR 27, Jan. 3, 1995; T.D. 8588, 60 FR 9776, 9777, Feb. 22, 1995, as amended by T.D. 8592, 60 FR 18741, April 13, 1995]

§ 1.702–1 Income and credits of partner.

(a) *General rule.* Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph. (For the taxable year in which a partner includes his distributive share of partnership taxable income, see section 706(a) and § 1.706–1(a). Such distributive share shall be determined as provided in section 704 and § 1.704–1.) Accordingly, in determining his income tax:

(1) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(2) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(3) Each partner shall take into account, as part of his gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), his distributive share of the combined net amount of such gains and losses of the partnership. The partnership shall not combine such items with items set forth in subparagraph (1) or (2) of this paragraph.

(4) Each partner shall take into account, as part of the charitable contributions paid by him, his distributive share of each class of charitable contributions paid by the partnership within the partnership's taxable year. Section 170 determines the extent to which such amount may be allowed as a deduction to the partner. For the definition of the term ''charitable contribution'', see section 170(c).

(5) Each partner shall take into account, as part of the dividends received by him from domestic corporations, his distributive share of dividends received by the partnership, with respect to which the partner is entitled to a credit under section 34 (for dividends received on or before December 31, 1964), an exclusion under section 116, or a deduction under part VIII, subchapter B, chapter 1 of the Code.

(6) Each partner shall take into account, as part of his taxes described in section 901 which have been paid or accrued to foreign countries or to possessions of the United States, his distributive share of such taxes which have been paid or accrued by the partnership, according to its method of treating such taxes. A partner may elect to treat his total amount of such taxes, including his distributive share of such taxes of the partnership, as a deduction under section 164 or as a credit under section 901, subject to the provisions of sections 901 through 905.

(7) Each partner shall take into account, as part of the partially tax-exempt interest received by him on obligations of the United States or on obligations of instrumentalities of the United States, as described in section 35 or section 242, his distributive share of such partially tax-exempt interest received by the partnership. However, if the partnership elects to amortize

premiums on bonds as provided in section 171, the amount received on such obligations by the partnership shall be reduced by the amortizable bond premium applicable to such obligations as provided in section 171(a)(3).

(8)(i) Each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: Recoveries of bad debts, prior taxes, and delinquency amounts (section 111); gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); nonbusiness expenses as described in section 212; medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); amounts representing taxes and interest paid to cooperative housing corporations (section 216); intangible drilling and developments costs (section 263(c)); pre-1970 exploration expenditures (section 615); certain mining exploration expenditures (section 617); income, gain, or loss to the partnership under section 751(b); and any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.

(ii) Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if separately taken into account by the controlled foreign corporation must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from gross income the part of the partner's distributive share which qualifies as earned income, as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner. This paragraph (a)(8)(ii) applies to taxable years beginning on or after July 23, 2002.

(iii) Each partner shall aggregate the amount of his separate deductions or exclusions and his distributive share of partnership deductions or exclusions separately stated in determining the amount allowable to him of any deduction or exclusion under subtitle A of the Code as to which a limitation is imposed. For example, partner A has individual domestic exploration expenditures of $300,000. He is also a member of the AB partnership which in 1971 in its first year of operation has foreign exploration expenditures of $400,000. A's distributable share of this item is $200,000. However, the total amount of his distributable share that A can deduct as exploration expenditures under section 617(a) is limited to $100,000 in view of the limitation provided in section 617(h). Therefore, the excess of $100,000 ($200,000 minus $100,000) is not deductible by A.

(9) Each partner shall also take into account separately his distributive share of the taxable income or loss of the partnership, exclusive of items requiring separate computations under subparagraphs (1) through (8) of this paragraph. For limitation on allowance of a partner's distributive share of partnership losses, see section 704(d) and paragraph (d) of § 1.704–1.

(b) *Character of items constituting distributive share.* The character in the hands of a partner of any item of income, gain, loss, deduction, or credit described in section 702(a)(1) through (8) shall be determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner.

Similarly, a partner's distributive share of partnership ''hobby losses'' (section 270) or his distributive share of partnership charitable contributions to organizations qualifying under section 170(b)(1)(A) retains such character in the hands of the partner.

(c) *Gross income of a partner.* (1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702(a)(1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012 (a));

(ii) In determining the application of the provisions permitting the spreading of income for services rendered over a 36-month period (section 1301, as in effect for taxable years beginning before January 1, 1964);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931);

(iv) In determining a partner's ''gross income from farming'' (sections 175 and 6073); and

(v) In determining whether the de minimis or full inclusion rules of section 954(b)(3) apply.

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501(e). For example, A, who is entitled to one-fourth of the profits of the ABCD partnership, which has $10,000 gross income and $2,000 taxable income, reports only $300 as his distributive share of partnership profits. A should have shown $500 as his distributive share of profits, which amount was derived from $2,500 of partnership gross income. However, since A included only $300 on his return without explaining in the return the difference of $200, he is regarded as having stated in his return only $1,500 ($300/$500 of $2,500) as gross income from the partnership.

(d) *Partners in community property States.* If separate returns are made by a husband and wife domiciled in a community property State, and only one spouse is a member of the partnership, the part of his or her distributive share of any item or items listed in paragraph (a) (1) through (9) of this section which is community property, or which is derived from community property, should be reported by the husband and wife in equal proportions.

(e) *Special rules on requirement to separately state meal, travel, and entertainment expenses.* Each partner shall take into account separately his or her distributive share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1987, and ending with or within partner's taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274 (1) (2), each partner shall take into account separately his or her distributive share of rents paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1989, and ending with or within partners' taxable years beginning on or after January 1, 1987.

(f) *Cross—references.* For special rules in accordance with the principles of section 702 applicable solely for the purpose of the tax imposed by section 56 (relating to the minimum tax for tax preferences) see §1.58–2(a). In the case of a disposition of an oil or gas property by the partnership, see the rules contained in section 613A(c)(7)(D) and § 1.613A–3(e).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7192, 37 FR 12949, June 30, 1972; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8247, 54 FR 13680, Apr. 5, 1989; T.D. 8348, 56 FR 21952, May 13, 1991; 57 FR 4913, Feb. 10, 1992; T.D. 9008, 67 FR 48023, July 23, 2002]

§ 1.702–2 Net operating loss deduction of partner.

For the purpose of determining a net operating loss deduction under section 172, a partner shall take into account his distributive share of items of income, gain, loss, deduction, or credit of the partnership. The character of any such item shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. See section 702(b) and paragraph (b) of § 1.702–1. To the extent necessary to determine the allowance under section 172(d)(4) of the nonbusiness deductions of a partner (arising from both partnership and nonpartnership sources), the partner shall separately take into account his distributive share of the deductions of the partnership which are not attributable to a trade or business and combine such amount with his nonbusiness deductions from nonpartnership sources. Such partner shall also separately take into account his distributive share of the gross income of the partnership not derived from a trade or business and combine such amount with his nonbusiness income from nonpartnership sources. See section 172 and the regulations thereunder.

§ 1.702–3T 4-Year spread (temporary).

(a) *Applicability*. This section applies to a partner in a partnership if—

(1) The partnership is required by section 806 of the Tax Reform Act of 1986 (the 1986 Act), Pub. L. 99–514, 100 Stat. 2362, to change its taxable year for the first taxable year beginning after December 31, 1986 (partnership's year of change); and

(2) As a result of such change in taxable year, items from more than one taxable year of the partnership would, but for the provisions of this section, be included in the taxable year of the partner with or within which the partnership's year of change ends.

(b) *Partner's treatment of items from the partnership's year of change*—(1) *In general.* Except as provided in paragraph (c) of this section, if a partner's share of "income items" exceeds the partner's share of "expense items," the partner's share of each and every income and expense item shall be taken into account ratably (and retain its character) over the partner's first 4 taxable years beginning with the partner's taxable year with or within which the partnership's year of change ends.

(2) *Definitions*—(i) *Income items.* For purposes of this section, the term *income items* means the sum of—

(A) The partner's distributive share of taxable income (exclusive of separately stated items) from the partnership's year of change,

(B) The partner's distributive share of all separately stated income or gain items from the partnership's year of change, and

(C) Any amount includible in the partner's income under section 707(c) on account of payments during the partnership's year of change.

(ii) *Expense items.* For purposes of this section, the term *expense items* means the sum of—

(A) The partner's distributive share of taxable loss (exclusive of separately stated items) from the partnership's year of change, and

(B) The partner's distributive share of all separately stated items of loss or deduction from the partnership's year of change.

(c) *Electing out of 4-year spread.* A partner may elect out of the rules of paragraph (b) of this section by meeting the requirements of § 301.9100–7T of this chapter (temporary regulations relating to elections under the Tax Reform Act of 1986).

(d) *Special rules for a partner that is a partnership or S corporation*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, a partner that is a partnership or S corporation may, if otherwise eligible, use the 4-year spread (with respect to partnership interests owned by the partner) described in this section.

(2) *Certain partners prohibited from using 4-year spread*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, a partner that is a partnership or S corporation may not use the 4-year spread (with respect to partnership interests owned by the partner) if such partner is also changing its taxable year pursuant to section 806 of the 1986 Act.

(ii) *Exception.* If a partner's year of change does not include any income or expense items with respect to the partnership's year of change, such partner may, if otherwise eligible, use the 4-year spread (with respect to such partnership interest) described in this section even though the partner is a partnership or S corporation. See examples 13 and 14 in paragraph (h) of this section.

(e) *Basis of partner's interest.* The basis of a partner's interest in a partnership shall be determined as if the partner elected not to spread the partnership items over 4 years, regardless of whether such election was in fact made. Thus, for example, if a partner is eligible for the 4-year spread and does not elect out of the 4-year spread pursuant to paragraph (c) of this section, the partner's basis in the partnership interest will be increased in the first year of the 4-year spread period by an amount equal to the excess of the income items over the expense items. However, the partner's basis will not be increased again, with respect to the unamortized income and expense items, as they are amortized over the 4-year spread period.

(f) *Effect on other provisions of the Code.* Except as provided in paragraph (e) of this section, determinations with respect to a partner, for purposes of other provisions of the Code, must be made with regard to the manner in which partnership items are taken into account under the rules of this section. Thus, for example, a partner who does not elect out of the 4-year spread must take into account, for purposes of determining net earnings from self-employment under section 1402(a) for a taxable year, only the ratable portion of partnership items for that taxable year.

(g) *Treatment of dispositions*—(1) *In general.* If a partnership interest is disposed of before the last taxable year in the 4-year spread period, unamortized income and expense items that are attributable to the interest disposed of and that would be taken into account by the partner for subsequent taxable years in the 4-year spread period shall be taken into account by the partner as determined under paragraph (g)(2) of this section. For purposes of this section, the term *disposed of* means any transfer, including (but not limited to) transfers by sale, exchange, gift, and by reason of death.

(2) *Year unamortized items taken into account*—(i) *In general.* If, at the end of a partner's taxable year, the fraction determined under paragraph (g)(2)(ii) of this section is—

(A) Greater than ⅔, the partner must continue to take the unamortized income and expense items into account ratably over the 4-year spread period;

(B) Greater than ⅓ but less than or equal to ⅔, the partner must, in addition to its ratable amortization, take into account in such year 50 percent of the income and expense items that would otherwise be unamortized at the end of such year (however, this paragraph (g)(2)(i)(B) is only applied once with respect to a partner's interest in a particular partnership); or

(C) Less than or equal to ⅓, the partner must take into account the entire balance of unamortized income and expense items in such year.

(ii) *Determination of fraction.* For purposes of paragraph (g)(2)(i) of this section, the numerator of the fraction is the partner's proportionate interest in the partnership at the end of the partner's taxable year and the denominator is the partner's proportionate interest in the partnership as of the last day of the partnership's year of change.

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

Example 1. Assume that P1, a partnership with a taxable year ending September 30, is required by the 1986 Act to change its taxable year to a calendar year. All of the partners of P1 are individual taxpayers reporting on a calendar year. P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for the short taxable year ending December 31, 1987. Based on the above facts, the partners of P1 are required to include the items from more than one taxable year of P1 in income for their 1987 taxable year. Thus, under paragraph (b) of this section, if a partner's share of income items exceeds the partner's share of expense items, the partner's share of each and every income and expense item shall be taken into account ratably by such partner in each of the partner's first four taxable years' beginning with the partner's 1987 taxable year, unless such partner elects under paragraph (c) of this section to include all such amounts in his 1987 taxable year.

Example 2. Assume the same facts as in example 1, except P1 is a personal service corporation with all of its employee-owners reporting on a calendar year. Although P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, neither P1 nor its employee-owners obtain the benefits of a 4-year spread. Pursuant to section 806(e)(2)(C) of the 1986 Act, the 4-year spread provision is only applicable to short taxable years of partnerships and S corporations required to change their taxable year under the 1986 Act.

Example 3. Assume the same facts as example 1 and that I is one of the individual partners of P1. Further assume that I's distributive share of P1's taxable income for the short taxable year ended December 31, 1987 (*i.e.,* P1's year of change), is $10,000. In addition, I has $8,000 of separately stated expense from P1's year of change. Since I's income items (*i.e.,* $10,000 of taxable income) exceed I's expense items (*i.e.,* $8,000 of separately stated expense) attributable to P1's year of change, I is eligible for the 4-year spread provided by this section. If I does not elect out of the 4-year spread, I will recognize $2,500 of taxable income and $2,000 of separately stated expense in his 1987 calendar year return. Assuming I does not dispose of his partnership interest in P1 by December 31, 1989, the remaining $7,500 of taxable income and $6,000 of separately stated expense will be amortized (and retain its character) over I's next three taxable years (*i.e.,* 1988, 1989 and 1990).

Example 4. Assume the same facts as example 3, except that I disposes of his entire interest in P1 during 1988. Pursuant to paragraph (g) of this section, I would recognize $7,500 of taxable income and $6,000 of separately stated expense in his 1988 calendar year return.

Example 5. Assume the same facts as in example 3, except that I disposes of 50 percent of his interest in P1 during 1989. Pursuant to paragraph (g) of this section, I would recognize $3,750 of taxable income in his 1989 calendar year return ($2,500 ratable portion for 1989 plus 50 percent of the $2,500 of income items that would otherwise be unamortized at the end of 1989). I would also recognize $3,000 of separately stated expense items in 1989 ($2,000 ratable portion for 1989 plus 50 percent of the $2,000 of separately stated expense items that would otherwise be unamortized at the end of 1989).

Example 6. Assume the same facts as in example 1, except that X, a personal service corporation as defined in section 441(i), is a partner of P1. X is a calendar year taxpayer, and thus is not required to change its taxable year under the 1986 Act. The same result occurs as in example 1 (*i.e.,* unless X elects to the contrary, X is required to include one fourth of its share of income and expense items from P1's year of change in the first four taxable years of X beginning with the 1987 taxable year).

Example 7. Assume the same facts as in example 6, except that X is a fiscal year personal service corporation with a taxable year ending September 30. X is required under the 1986 Act to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for its short year ending December 31, 1987. Based on the above facts, X is not required to include the items from more than one taxable year of P1 in any one taxable year of X. Thus, the provisions of this section do not apply to X, and X is required to include the full amount of income and expense items from P1's year of change in X's taxable income for X's short year ending December 31. Under section 443 of the Code, X is required to annualize the taxable income for its short year ending December 31, 1987.

Example 8. Assume that P2 is a partnership with a taxable year ending September 30. Under the 1986 Act, P2 would have been required to change its taxable year to a calendar year, effective for the taxable year beginning October 1, 1987. However, P2 properly changed its taxable year to a calendar year for the year beginning October 1, 1986, and filed a return for the short period ending December 31, 1986. The provisions of the 1986 Act do not apply to P2 because the short year ending December 31, 1986, was not required by the amendments made by section 806 of the 1986 Act. Thus, the partners of P2 are required to take all items of income and expense for the short taxable year ending December 31, 1986, into account for the taxable year with or within which such short year ends.

Example 9. Assume that P3 is a partnership with a taxable year ending March 31 and I, a calendar year individual, is a partner in P3. Under the 1986 Act, P3 would have been required to change its taxable year to a calendar year. However, under Rev. Proc. 87–32, P3 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987. Thus, P3 is required to change its taxable year under section 806 of the 1986 Act, and I is required to include items from more than one taxable year of P3 in one of her taxable years. Furthermore, I's share of P3's income items exceeds her share of P3's expense items for the short period April 1, 1987 through June 30, 1987. Accordingly, under this section, unless I elects to the contrary, I is required to take one fourth of her share of items of income and expense from P3's short taxable year ending June 30, 1987 into account for her taxable year ending December 31, 1987.

Example 10. Assume that P4 is a partnership with a taxable year ending March 31. Y, a C corporation, owns a 51 percent interest in the profits and capital of P4. Y reports its income on the basis of a taxable year ending March 31. P4 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987, under Rev. Proc. 87–32. Under the above facts, P4 is not required to change its taxable year because its March 31 taxable year was the taxable year of Y, the partner owning a majority of the partnership's profits and capital. Therefore, the remaining partners of P4 owning 49 percent of the profits and capital are not permitted the 4-year spread of the items of income and expense with respect to the short year, even though they may be required to include their distributive share of P4's items from more than one taxable year in one of their years.

Example 11. Assume that X and Y are C corporations with taxable years ending June 30. Each owns a 50-percent interest in the profits and capital of partnership P5. P5 has a taxable year ending March 31. Assume that P5 cannot establish a business purpose in order to retain a taxable year ending March 31, and thus P5 must change to a June 30 taxable year, the taxable year of its partners. Furthermore, assume that X's share of P5's income items exceeds its share of P5's expense items for P5's short taxable year ending June 30, 1987. Unless X elects out of the 4-year spread, the taxable year ending June 30, 1987, is the first of the four taxable years in which X must take into account its share of the items of income and expense resulting from P5's short taxable year ending June 30, 1987.

Example 12. Assume that I, an individual who reports income on the basis of the calendar year, is a partner in two partnerships, P6 and P7. Both partnerships have a taxable year ending September 30. Neither partnership can establish a business purpose for retaining its taxable year. Consequently, each partnership will change its taxable year to December 31, for the taxable year beginning October 1, 1987. The election to avoid a 4-year spread is made at the partner level; in addition, a partner may make such elections on a partnership-by-partnership basis. Thus, assuming I is eligible to obtain the 4-year spread with respect to income and expense items from partnerships P6 and P7, I may use the 4-year spread with respect to items from P6, while not using the 4-year spread with respect to items from P7.

Example 13. I, an individual taxpayer using a calendar year, owns an interest in P8, a partnership using a taxable year ending June 30. Furthermore, P8 owns an interest in P9, a partnership with a taxable year ending March 31. Under section 806 of the 1986 Act, P8 will be required to change to a taxable year ending December 31, while P9 will be required to change to a taxable year ending June 30. As a result, P8's year of change will be July 1 through December 31, 1987, while P9's year of change will be from April 1 through June 30, 1987. Since P9's year of change does not end with or within P8's year of change, paragraph (d)(2) of this section does not prevent P8 from obtaining a 4-year spread with respect to its interest in P9.

Example 14. The facts are the same as in example 13, except that P9 has a taxable year ending September 30, and under the 1986 Act P9 is required to change to a taxable year ending December 31. Therefore, P9's year of change will be from October 1, 1987 through December 31, 1987. Although P8's year of change from July 1, 1987 through December 31, 1987 includes two taxable years of P9 (*i.e.*, October 1, 1986 through September 30, 1987 and October 1, 1987 through December 31, 1987), paragraph (d)(2) of this section prohibits P8 from using the 4-year spread with respect to its interest in P9, because P9's year of change ends with or within P8's year of change.

[T.D. 8167, 52 FR 48530, Dec. 23, 1987, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.703–1 Partnership computations.

(a) *Income and deductions.* (1) The taxable income of a partnership shall be computed in the same manner as the taxable income of an individual, except as otherwise provided in this section. A partnership is required to state separately in its return the items described in section 702(a)(1) through (7) and, in addition, to attach to its return a statement setting forth separately those items described in section 702(a)(8) which the partner is required to take into account separately in determining his income tax. See paragraph (a)(8) of § 1.702–1. The partnership is further required to compute and to state separately in its return:

(i) As taxable income under section 702(a)(9), the total of all other items of gross income (not separately stated) over the total of all other allowable deductions (not separately stated), or

(ii) As loss under section 702(a)(9), the total of all other allowable deductions (not separately stated) over the total of all other items of gross income (not separately stated).

The taxable income or loss so computed shall be accounted for by the partners in accordance with their partnership agreement.

(2) The partnership is not allowed the following deductions:

(i) The standard deduction provided in section 141.

(ii) The deduction for personal exemptions provided in section 151.

(iii) The deduction provided in section 164(a) for taxes, described in section 901, paid or accrued to foreign countries or possessions of the United States. Each partner's distributive share of such taxes shall be accounted for separately by him as provided in section 702(a)(6).

(iv) The deduction for charitable contributions provided in section 170. Each partner is considered as having paid within his taxable year his distributive share of any contribution or gift, payment of which was actually made by the partnership within its taxable year ending within or with the partner's taxable year. This item shall be accounted for separately by the partners as provided in section 702(a)(4). See also paragraph (b) of § 1.702–1.

(v) The net operating loss deduction provided in section 172. See § 1.702–2.

(vi) The additional itemized deductions for individuals provided in part VII, subchapter B, chapter 1 of the Code, as follows: Expenses for production of income (section 212); medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); and amounts representing taxes and interest paid to cooperative housing corporation (section 216). However, see paragraph (a)(8) of § 1.702–1.

(vii) The deduction for depletion under section 611 with respect to domestic oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after such year.

(viii) The deduction for capital gains provided by section 1202 and the deduction for capital loss carryover provided by section 1212.

(b) *Elections of the partnership*—(1) *General rule.* Any elections (other than those described in subparagraph (2) of this paragraph) affecting the computation of income derived from a partnership shall be made by the partnership. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, shall be made by the partnership and not by the partners separately. All partnership elections are applicable to all partners equally, but any election made by a partnership shall not apply to any partner's nonpartnership interests.

(2) *Exceptions.* (i) Each partner shall add his distributive share of taxes described in section 901 paid or accrued by the partnership to foreign countries or possessions of the United States (according to its method of treating such taxes) to any such taxes paid or accrued by him (according to his method of treating such taxes), and may elect to use the total amount either as a credit against tax or as a deduction from income.

(ii) Each partner shall add his distributive share of expenses described in section 615 or section 617 paid or accrued by the partnership to any such expenses paid or accrued by him and shall treat the total amount according to his method of treating such expenses, notwithstanding the treatment of the expenses by the partnership.

(iii) Each partner who is a nonresident alien individual or a foreign corporation shall add his distributive share of income derived by the partnership from real property located in the United States, as described in section 871(d)(1) or 882(d)(1), to any such income derived by him and may elect under § 1.871–10 to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7192, 37 FR 12949, June 30, 1972; T.D. 7332, 39 FR 44232, Dec. 23, 1974; T.D. 8348, 56 FR 21952, May 13, 1991]

§ 1.704–1 Partner's distributive share.

(a) *Effect of partnership agreement.* A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) *Determination of partner's distributive share*—(0) *Cross-references.*

Heading	Section
Cross-references	1.704–1(b)(0)
In general	1.704–1(b)(1)
Basic principles	1.704–1(b)(1)(i)
Effective dates	1.704–1(b)(1)(ii)
Effect of other sections	1.704–1(b)(1)(iii)
Other possible tax consequences.	1.704–1(b)(1)(iv)
Purported allocations	1.704–1(b)(1)(v)
Section 704(c) determinations.	1.704–1(b)(1)(vi)
Bottom line allocations	1.704–1(b)(1)(vii)
Substantial economic effect	1.704–1(b)(2)
Two-part analysis	1.704–1(b)(2)(i)
Economic effect	1.704–1(b)(2)(ii)
Fundamental principles.	1.704–1(b)(2)(ii)(*a*)
Three requirements	1.704–1(b)(2)(ii)(*b*)
Obligation to restore deficit.	1.704–1(b)(2)(ii)(*c*)
Alternate test for economic effect.	1.704–1(b)(2)(ii)(*d*)
Partial economic effect.	1.704–1(b)(2)(ii)(*e*)
Reduction of obligation to restore.	1.704–1(b)(2)(ii)(*f*)
Liquidation defined	1.704–1(b)(2)(ii)(*g*)
Partnership agreement defined.	1.704–1(b)(2)(ii)(*h*)
Economic effect equivalence.	1.704–1(b)(2)(ii)(*i*)
Substantiality	1.704–1(b)(2)(iii)
General rules	1.704–1(b)(2)(iii)(*a*)
Shifting tax consequences.	1.704–1(b)(2)(iii)(*b*)
Transitory allocations.	1.704–1(b)(2)(iii)(*c*)
Maintenance of capital accounts.	1.704–1(b)(2)(iv)
In general	1.704–1(b)(2)(iv)(*a*)
Basic rules	1.704–1(b)(2)(iv)(*b*)
Treatment of liabilities	1.704–1(b)(2)(iv)(*c*)
Contributed property	1.704–1(b)(2)(iv)(*d*)
In general	1.704–1(b)(2)(iv)(*d*)(*1*)
Contribution of promissory notes.	1.704–1(b)(2)(iv)(*d*)(*2*)
Section 704(c) considerations.	1.704–1(b)(2)(*iv*)(*d*)(*3*)
Distributed property	1.704–1(b)(2)(iv)(*e*)
In general	1.704–1(b)(2)(iv)(*e*)(*1*)
Distribution of promissory notes.	1.704–1(b)(2)(iv)(*e*)(*2*)
Revaluations of property	1.704–1(b)(2)(iv)(*f*)
Adjustments to reflect book value.	1.704–1(b)(2)(iv)(*g*)
In general	1.704–1(b)(2)(iv)(*g*)(*1*)
Payables and receivables.	1.704–1(b)(2)(iv)(*g*)(*2*)
Determining amount of book items.	1.704–1(b)(2)(iv)(*g*)(*3*)
Determinations of fair market value.	1.704–1(b)(2)(iv)(*h*)
Section 705(a)(2)(B) expenditures.	1.704–1(b)(2)(iv)(*i*)
In general	1.704–1(b)(2)(iv)(*i*)(*1*)
Expenses described in section 709.	1.704–1(b)(2)(iv)(*i*)(*2*)
Disallowed losses	1.704–1(b)(2)(iv)(*i*)(*3*)
Basis adjustments to section 38 property.	1.704–1(b)(2)(iv)(*j*)
Depletion of oil and gas properties.	1.704–1(b)(2)(iv)(*k*)
In general	1.704–1(b)(2)(iv)(*k*)(*1*)
Simulated depletion	1.704–1(b)(2)(iv)(*k*)(*2*)
Actual depletion	1.704–1(b)(2)(iv)(*k*)(*3*)
Effect of book values	1.704–1(b)(2)(iv)(*k*)(*4*)
Transfers of partnership interests.	1.704–1(b)(2)(iv)(l)
Section 754 elections	1.704–1(b)(2)(iv)(m)
In general	1.704–1(b)(2)(iv)(*m*)(*1*)
Section 743 adjustments.	1.704–1(b)(2)(iv)(*m*)(*2*)
Section 732 adjustments.	1.704–1(b)(2)(iv)(*m*)(*3*)
Section 734 adjustments.	1.704–1(b)(2) iv)(*m*)(*4*)
Limitations on adjustments.	1.704–1(b)(2) iv)(*m*)(*5*)
Partnership level characterization.	1.704–1(b)(2)(iv)(*n*)
Guaranteed payments	1.704–1(b)(2)(iv)(*o*)
Minor discrepancies	1.704–1(b)(2)(iv)(*p*)
Adjustments where guidance is lacking.	1.704–1(b)(2)(iv)(*q*)
Restatement of capital accounts.	1.704–1(b)(2)(iv)(*r*)
Partner's interest in the partnership.	1.704–1(b)(3)
In general	1.704–1(b)(3)(i)
Factors considered	1.704–1(b)(3)(ii)
Certain determinations.	1.704–1(b)(3)(iii)
Special rules	1.704–1(b)(4)
Allocations to reflect revaluations.	1.704–1(b)(4)(i)
Credits	1.704–1(b)(4)(ii)
Excess percentage depletion.	1.704–1(b)(4)(iii)
Allocations attributable to nonrecourse liabilities.	1.704–1(b)(4)(iv)
Allocations under section 613A(c(7)(D).	1.704–1(b)(4)(v)
Amendments to partnership agreement.	1.704–1(b)(4)(vi)
Recapture	1.704–1(b)(4)(vii)
Examples	1.704–1(b)(5)

(1) *In general*—(i) *Basic principles.* Under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such

allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph (b)(2) of this section. Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership. See paragraph (b)(3) of this section. Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules contained in paragraph (b)(4) of this section and § 1.704–2. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership (determined under paragraph (b)(3) of this section).

(ii) *Effective dates.* The provisions of this paragraph are effective for partnership taxable years beginning after December 31, 1975. However, for partnership taxable years beginning after December 31, 1975, but before May 1, 1986, (January 1, 1987, in the case of allocations of nonrecourse deductions as defined in paragraph (b)(4)(iv)(*a*) of this section) an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that is not respected under this paragraph nevertheless will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of this paragraph in effect for partnership taxable years beginning before May 1, 1986.

(iii) *Effect of other sections.* The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, *e.g., Goldstein v. Commissioner,* 364 F.2d 734 (2d Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of § 1.751–1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in § 1.743–1 (see paragraph (b)(2)(iv)(*m*)(*2*) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

(iv) *Other possible tax consequences.* Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of § 1.46–3, § 1.47–6, paragraph (b)(1) of § 1.721–1 (and related principles), and paragraph

(e) of § 1.752–1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

(v) *Purported allocations.* Section 704(b) and this paragraph do not apply to a purported allocation if it is made to a person who is not a partner of the partnership (see section 7701(a)(2) and paragraph (d) of § 301.7701–3) or to a person who is not receiving the purported allocation in his capacity as a partner (see section 707(a) and paragraph (a) of § 1.707–1).

(vi) *Section 704(c) determinations.* Section 704(c) and § 1.704–3 generally require that if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined so as to take account of the variation between the adjusted tax basis and fair market value of the property. Although section 704(b) does not directly determine the partners' distributive shares of tax items governed by section 704(c), the partners' distributive shares of tax items may be determined under section 704(c) and § 1.704–3 (depending on the allocation method chosen by the partnership under § 1.704–3) with reference to the partners' distributive shares of the corresponding book items, as determined under section 704(b) and this paragraph. (See paragraphs (b)(2)(iv)(*d*) and (b)(4)(i) of this section.) See § 1.704–3 for methods of making allocations under section 704(c), and § 1.704–3(d)(2) for a special rule in determining the amount of book items if the remedial allocation method is chosen by the partnership. See also paragraph (b)(5) *Example (13)* (i) of this section.

(vii) *Bottom line allocations.* Section 704(b) and this paragraph are applicable to allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain, loss, deduction, and credit, and allocations of partnership net or ''bottom line'' taxable income and loss. An allocation to a partner of a share of partnership net or ''bottom line'' taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or ''bottom line'' taxable income or loss. See example 15(i) of paragraph (b)(5) of this section.

(2) *Substantial economic effect*—(i) *Two-part analysis.* The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section). Second, the economic effect of the allocation must be substantial (within the meaning of paragraph (b)(2)(iii) of this section).

(ii) *Economic effect*—(*a*) *Fundamental principles.* In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

(*b*) *Three requirements.* Based on the principles contained in paragraph (b)(2)(ii)(*a*) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides—

(*1*) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(*2*) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (*2*) and requirement (*3*) of this paragraph (b)(2)(ii)(*b*)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(*3*) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (*3*)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (*2*) of this paragraph (b)(2)(*ii*)(*b*)).

For purposes of the preceding sentence, a partnership taxable year shall be determined without regard to section 706(c)(2)(A). Requirements (*2*) and (*3*) of this paragraph (b)(2)(ii)(*b*) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(*a*) of this section. In addition, requirement (*2*) of this paragraph (b)(2)(ii)(*b*) is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(*f*) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in that requirement (*2*) in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances. See examples 1(i) and (ii), (4)(i), (8)(i), and (16)(i) of paragraph (b)(5) of this section.

(*c*) *Obligation to restore deficit.* If a partner is not expressly obligated to restore the deficit balance in his capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section) to the extent of—

(*1*) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(*2*) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by State or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker),

provided that such note or obligation is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation). If a promissory note referred to in the previous sentence is negotiable, a partner will be considered required to satisfy such note within the time period specified in such sentence if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(*d*)(*2*) of this section. See examples (1)(ix) and (x) of paragraph (b)(5) of this section. A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section) to the extent such partner's obligation is not legally enforceable, or the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation. See paragraphs (b)(2)(ii)(*f*), (b)(2)(ii)(*h*), and (b)(4)(vi) of this section for other rules regarding such obligation. For purposes of this paragraph (b)(2), if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988 and the maker of such note is a person related to such partner (within the meaning of § 1.752–1T(h), but without regard to subdivision (4) of that section), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(*d*) *Alternate test for economic effect.* If—

(*1*) Requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied, and

(*2*) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(*3*) The partnership agreement contains a ''qualified income offset,''

such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(*d*) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for—

(*4*) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(*k*) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(*5*) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of § 751–1, and

(*6*) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(*e*) of this section or under § 1.704–2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain).

For purposes of determining the amount of expected distributions and expected capital account increases described in (*6*) above, the rule set out in paragraph (b)(2)(iii)(*c*) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a ''qualified income offset'' if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (*4*), (*5*), or (*6*) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied. See examples (1)(iii), (iv), (v), (vi), (viii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

(*e*) *Partial economic effect.* If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated shall consist of a proportionate share of all items that made up the allocation to such partner for such year. See examples (15) (ii) and (iii) of paragraph (b)(5) of this section.

(*f*) *Reduction of obligation to restore.* If requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied, a partner's obligation to restore the deficit balance in his capital account (or any limited dollar amount thereof) to the partnership may be eliminated or reduced as of the end of a partnership taxable year without affecting the validity of prior allocations (see paragraph (b)(4)(vi) of this section) to the extent the deficit balance (if any) in such partner's capital account, after reduction for the items described in (*4*), (*5*), and (*6*) of paragraph (b)(2)(ii)(*d*) of this section, will not exceed the partner's remaining obligation (if any) to restore the deficit balance in his capital account. See example (1)(viii) of paragraph (b)(5) of this section.

(*g*) *Liquidation defined.* For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (*1*) the date upon which there is a liquidation of the partnership, or (*2*) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of § 1.761–1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (*3*) the date upon which the partnership is terminated under section 708(b)(1), or (*4*) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (*2*) and (*3*) of paragraph (b)(2)(ii)(*b*) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (*2*) of paragraph (b)(2)(ii)(*b*) of this section or deferring any partner's obligations under requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section.

(*h*) *Partnership agreement defined.* For purposes of this paragraph, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases to be made in accordance with the partners' positive capital account balances (requirement (*2*) of paragraph (b)(2)(ii)(*b*) of this section), and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account (requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section), all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options, and other buy-sell agreements, and any other ''stop-loss'' arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending upon the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.) In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement (see the last sentence of paragraph (c) of § 1.761–1). For purposes of this paragraph (b)(2)(ii)(*h*), an agreement with a partner or a partnership shall include an agreement with a person related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to such partner or partnership. For purposes of the preceding sentence, sections 267(b) and

707(b)(1) shall be applied for partnership taxable years beginning after December 29, 1988 by *(1)* substituting ''80 percent or more'' for ''more than 50 percent'' each place it appears in such sections, *(2)* excluding brothers and sisters from the members of a person's family, and *(3)* disregarding § 267(f)(1)(A).

(*i*) *Economic effect equivalence.* Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (*1*), (*2*), and (*3*) of paragraph (b)(2)(ii)(*b*) of this section had been satisfied, regardless of the economic performance of the partnership. See examples (4)(ii) and (iii) of paragraph (b)(5) of this section.

(iii) *Substantiality*—(*a*) *General rules.* Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (*1*) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (*2*) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. See examples 5 and 9 of paragraph (b)(5) of this section. The economic effect of an allocation is not substantial in the two situtations described in paragraphs (b)(2)(iii) (*b*) and (*c*) of this section. However, even if an allocation is not described therein, its economic effect may be insubstantial under the general rules stated in this paragraph (b)(2)(iii)(*a*). References in this paragraph (b)(2)(iii) to allocations include capital account adjustments made pursuant to paragraph (b)(2)(iv)(*k*) of this section.

(*b*) *Shifting tax consequences.* The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that—

(*1*) The net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and

(*2*) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).

If, at the end of a partnership taxable year to which an allocation (or allocations) relates, the net increases and decreases that are recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the allocation (or allocations) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (*2*) above) less than it would have been had the allocation (or allocations) not been contained in the partnership agreement, it will be presumed that, at the time the allocation (or allocations) became part of such partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples 6, 7(ii) and (iii), and (10)(ii) of paragraph (b)(5) of this section.

(*c*) *Transitory allocations.* If a partnership agreement provides for the possibility that one or more allocations (the ''original allocation(s)'') will be largely offset by one or more other allocations (the ''offsetting allocation(s)''), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that—

(*1*) The net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement, and

(*2*) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)

the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial. If, at the end of a partnership taxable year to which an offsetting allocation(s) relates, the net increases and decreases recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the original allocation(s) and the offsetting allocation(s) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (*2*) above) less than it would have been had such allocations not been contained in the partnership agreement, it will be presumed that, at the time the allocations became part of the partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (1)(xi), (2), (3), (7), (8)(ii), and (17) of paragraph (b)(5) of this section. Notwithstanding the foregoing, the original allocation(s) and the offsetting allocation(s) will not be insubstantial (under this paragraph (b)(2)(iii)(*c*)) and, for purposes of paragraph (b)(2)(iii)(*a*), it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis). See example 2 of paragraph (b)(5) of this section. For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(*d*)(*6*) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. See examples 1 (vi) and (xi) of paragraph (b)(5) of this section.

(iv) *Maintenance of capital accounts—(a) In general.* The economic effect test described in paragraph (b)(2)(ii) of this section requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement. Except as otherwise provided in paragraph (b)(2)(ii)(*i*) of this section, an allocation of income, gain, loss, or deduction will not have economic effect under paragraph (b)(2)(ii) of this section, and will not be deemed to be in accordance with a partner's interest in the partnership under paragraph (b)(4) of this section, unless the capital accounts of the partners are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of this paragraph (b)(2)(iv).

(*b*) *Basic rules.* Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by (*1*) the amount of money contributed by him to the partnership, (*2*) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752), and (*3*) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(*g*) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and is decreased by (*4*) the amount of money distributed to him by the partnership, (*5*) the fair market value of property distributed to him by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under section 752), (*6*) allocations to him of expenditures of the partnership described in section 705 (a)(2)(B), and (*7*) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(*g*) of this section, but excluding items described in (*6*) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv). For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (*e.g.*, general or limited) and regardless of the time or manner in which such interests were acquired.

(*c*) *Treatment of liabilities.* For purposes of this paragraph (b)(2)(iv), (*1*) money contributed by a partner to a partnership includes the amount of any partnership liabilities that are assumed by such partner (other than liabilities described in paragraph (b)(2)(iv)(*b*)(*5*) of this section that are assumed by a distributee partner) but does not include increases in such partner's share of partnership liabilities (see section 752(a)), and (*2*) money distributed to a partner by a partnership includes the amount of such partner's individual liabilities that are assumed by the partnership (other than liabilities described in paragraph (b)(2)(iv)(*b*)(*2*) of this section that are assumed by the partnership) but does not include decreases in such partner's share of partnership liabilities (see section 752(b)). For purposes of this paragraph (b)(2)(iv)(*c*), liabilities are considered assumed only to the extent the assuming party is thereby subjected to personal liability with respect to such obligation, the obligee is aware of the assumption and can directly enforce the assuming party's obligation, and, as between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable.

(*d*) *Contributed property*—(*1*) *In general.* The basic capital accounting rules contained in paragraph (b)(2)(iv)(*b*) of this section require that a partner's capital account be increased by the fair market value of property contributed to the partnership by such partner on the date of contribution. See *Example 13*(i) of paragraph (b)(5) of this section. Consistent with section 752(c), section 7701(g) does not apply in determining such fair market value.

(*2*) *Contribution of promissory notes.* Notwithstanding the general rule of paragraph (b)(2)(iv)(*b*)(*2*) of this section, except as provided in this paragraph (b)(2)(iv)(*d*)(*2*), if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner's capital account will be increased with respect to such note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note. See example (1)(ix) of paragraph (b)(5) of this section. The first sentence of this paragraph (b)(2)(iv)(*d*)(*2*) shall not apply if the note referred to therein is readily tradable on an established securities market. See also paragraph (b)(2)(ii)(*c*) of this section. Furthermore, a partner whose interest is liquidated will be considered as satisfying his obligation to restore the deficit balance in his capital account to the extent of (*i*) the fair market value, at the time of contribution, of any negotiable promissory note (of which such partner is the maker) that such partner contributes to the partnership on or after the date his interest is liquidated and within the time specified in paragraph (b)(2)(ii)(*b*)(*3*) of this section, and (*ii*) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partner is the maker) that such partner previously contributed to the partnership. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at the time of valuation.

(*3*) *Section 704(c) considerations.* Section 704(c) and §1.704–3 govern the determination of the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to property contributed to a partnership (see paragraph (b)(1)(vi) of this section). In cases where section 704(c) and §1.704–3 apply to partnership property, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(*g*) of this section for allocations to them of income, gain, loss, and deduction (including depreciation, depletion, amortization, or other cost recovery) as computed for book purposes, with respect to the property. See, however, §1.704–3(d)(2) for a special rule in determining the amount of book items if the partnership chooses the remedial allocation method. See also *Example (13)* (i) of paragraph (b)(5) of this section. Capital accounts are not adjusted to reflect allocations under section 704(c) and §1.704–3 (e.g., tax allocations of precontribution gain or loss).

(*e*) *Distributed property*—(*1*) *In general.* The basic capital accounting rules contained in paragraph (b)(2)(iv) (*b*) of this section require that a partner's capital account be decreased by the fair market value of property distributed by the partnership (without regard to section 7701(g)) to such partner (whether in connection with a liquidation or otherwise). To satisfy this requirement, the capital accounts of the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property (taking section 7701(g) into account) on the date of distribution. See example (14)(v) of paragraph (b)(5) of this section.

(*2*) *Distribution of promissory notes.* Notwithstanding the general rule of paragraph (b)(2)(iv)(*b*)(*5*), except as provided in this paragraph (b)(2)(iv)(*e*)(*2*), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (*i*) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(*b*)(*2*) of this section, and (*ii*) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable Federal rate at time of valuation.

(*f*) *Revaluations of property*. A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(*1*) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, and

(*2*) The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date, and

(*3*) The partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(*g*) of this section for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property, and

(*4*) The partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and

(*5*) The adjustments are made principally for a substantial non-tax business purpose—

(*i*) In connection with a contribution of money or other property (other than a *de minimis* amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or

(*ii*) In connection with the liquidation of the partnership or a distribution of money or other property (other than a *de minimis* amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or

(*iii*) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

See examples 14 and 18 of paragraph (b)(5) of this section. If the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquished to the partnership, paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied to determine the partners' distributive shares of depreciation, depletion, amortization, and gain or loss as computed for tax purposes, with respect to such property.

(*g*) *Adjustments to reflect book value*—(*1*) *In general.* Under paragraphs (b)(2)(iv)(*d*) and (b)(2)(iv)(*f*) of this section, property may be properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property. In these circumstances, paragraphs (b)(2)(iv)(*d*)(*3*) and (b)(2)(iv)(*f*)(*3*) of this section provide that the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires the partners' capital accounts to be adjusted in accordance with this paragraph (b)(2)(iv)(*g*) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property. In determining whether the economic effect of an allocation of book items is substantial, consideration will be given to the effect of such allocation on the determination of the partners' distributive shares of corresponding tax items under section 704(c) and paragraph (b)(4)(i) of this section. See example 17 of paragraph (b)(5) of this section. If an allocation of book items under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such items will be reallocated in accordance with the partners' interests in the partnership, and such reallocation will be the basis upon which the partners' distributive shares of the corresponding tax items are determined under section 704(c) and paragraph (b)(4)(i) of this section. See examples 13, 14, and 18 of paragraph (b)(5) of this section.

(*2*) *Payables and receivables.* References in this paragraph (b)(2)(iv) and paragraph (b)(4)(i) of this section to book and tax depreciation, depletion, amortization, and gain or loss with respect to property that has an adjusted tax basis that differs from book value include, under analogous rules and principles, the unrealized income or deduction with respect to accounts receivable, accounts payable, and other accrued but unpaid items.

(*3*) *Determining amount of book items.* The partners' capital accounts will not be considered adjusted in accordance with this paragraph (b)(2)(iv)(*g*) unless the amount of book depreciation, depletion, or amortization for a period with respect to an item of partnership property is the amount that bears the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to such property for such period bears to the adjusted tax basis of such property. If such property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership.

(*h*) *Determinations of fair market value.* For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (*1*) such value is reasonably agreed to among the partners in arm's-length negotiations, and (*2*) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.

(*i*) *Section 705(a)(2)(B) expenditures—(1) In general.* The basic capital accounting rules contained in paragraph (b)(2)(iv)(*b*) of this section require that a partner's capital account be decreased by allocations made to such partner of expenditures described in section 705(a)(2)(B). See example 11 of paragraph (b)(5) of this section. If an allocation of these expenditures under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such expenditures will be reallocated in accordance with the partners' interest in the partnership.

(*2*) *Expenses described in section 709.* Except for amounts with respect to which an election is properly made under section 709(b), amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such a partnership shall, solely for purposes of this paragraph, be treated as section 705(a)(2)(B) expenditures, and upon liquidation of the partnership no further capital account adjustments will be made in respect thereof.

(*3*) *Disallowed losses.* If a deduction for a loss incurred in connection with the sale or exchange of partnership property is disallowed to the partnership under section 267(a)(1) or section 707(b), that deduction shall, solely for purposes of this paragraph, be treated as a section 705(a)(2)(B) expenditure.

(*j*) *Basis adjustments to section 38 property.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted by the partners' shares of any upward or downward basis adjustments allocated to them under this paragraph (b)(2)(iv)(*j*). When there is a reduction in the adjusted tax basis of partnership section 38 property under section 48(q)(1) or section 48(q)(3), section 48(q)(6) provides for an equivalent downward adjustment to the aggregate basis of partnership interests (and no additional adjustment is made under section 705(a)(2)(B)). These downward basis adjustments shall be shared among the partners in the same proportion as the adjusted tax basis or cost of (or the qualified investment in) such section 38 property is allocated among the partners under paragraph (f) of §1.46–3 (or paragraph (a)(4)(iv) of §1.48–8). Conversely, when there is an increase in the adjusted tax basis of partnership section 38 property under section 48(q)(2), section 48(q)(6) provides for an equivalent upward adjustment to the aggregate basis of partnership interests. These upward adjustments shall be allocated among the partners in the same proportion as the investment tax credit from such property is recaptured by the partners under §1.47–6.

(*k*) *Depletion of oil and gas properties*—(1) *In general.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted for depletion and gain or loss with respect to the oil or gas properties of the partnership in accordance with this paragraph (b)(2)(iv)(*k*).

(*2*) *Simulated depletion.* Except as provided in paragraph (b)(2)(iv)(*k*) (*3*) of this section, a partnership shall, solely for purposes of maintaining capital accounts under this paragraph, compute simulated depletion allowances with respect to its oil and gas properties at the partnership level. These allowances shall be computed on each depletable oil or gas property of the partnership by using either the cost depletion method or the percentage depletion method (computed in accordance with section 613 at the rates specified in section 613A(c)(5) without regard to the limitations of section 613A, which theoretically could apply to any partner) for each partnership taxable year that the property is owned by the partnership and subject to depletion. The choice between the simulated cost depletion method and the simulated percentage depletion method shall be made on a property-by-property basis in the first partnership taxable year beginning after April 30, 1986, for which it is relevent for the property, and shall be binding for all partnership taxable years during which the oil or gas property is held by the partnership. The partnership shall make downward adjustments to the capital accounts of the partners for the simulated depletion allowance with respect to each oil or gas property of the partnership, in the same proportion as such partners (or their precedecessors in interest) were properly allocated the adjusted tax basis of each such property. The aggregate capital account adjustments for simulated percentage depletion allowances with respect to an oil or gas property of the partnership shall not exceed the aggregate adjusted tax basis allocated to the partners with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, such partnership's simulated gain or loss shall be determined by subtracting its simulated adjusted basis in such property from the amount realized upon such disposition. (The partnership's simulated adjusted basis in an oil or gas property is determined in the same manner as adjusted tax basis except that simulated depletion allowances are taken into account instead of actual depletion allowances.) The capital accounts of the partners shall be adjusted upward by the amount of any simulated gain in proportion to such partners' allocable shares of the portion of the total amount realized from the disposition of such property that exceeds the partnership's simulated adjusted basis in such property. The capital accounts of such partners shall be adjusted downward by the amount of any simulated loss in proportion to such partners' allocable shares of the total amount realized from the disposition of such property that represents recovery of the partnership's simulated adjusted basis in such property. See section 613A(c)(7)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section. See example (19)(iv) of paragraph (b)(5) of this section.

(*3*) *Actual depletion.* Pursuant to section 613A(c)(7)(D) and the regulations thereunder, the depletion allowance under section 611 with respect to the oil and gas properties of a partnership is computed separately by the partners. Accordingly, in lieu of adjusting the partner's capital accounts as provided in paragraph (b)(2)(iv)(*k*)(*2*) of this section, the partnership may make downward adjustments to the capital account of each partner equal to such partner's depletion allowance with respect to each oil or gas property of the partnership (for the partner's taxable year that ends with or within the partnership's taxable year). The aggregate adjustments to the capital account of a partner for depletion allowances with respect to an oil or gas property of the partnership shall not exceed the adjusted tax basis allocated to such partner with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, the capital account of each partner shall be adjusted upward by the amount of any excess of such partner's allocable share of the total amount realized from the disposition of such property over such partner's remaining adjusted tax basis in such property. If there is no such excess, the capital account of such partner shall be adjusted downward by the amount of any excess of such partner's remaining adjusted tax basis in such property over such partner's allocable share of the total amount realized from the disposition thereof. See section 613A(c)(7)(4)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section.

(*4*) *Effect of book values.* If an oil or gas property of the partnership is, under paragraphs (b)(2)(iv(*d*) or (b)(2)(iv)(*f*) of this section, properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, the rules contained in this paragraph (b)(2)(iv)(*k*) and paragraph (b)(4)(v) of this section shall be applied with reference to such book value. A revaluation of a partnership oil or gas property under paragraph (b)(2)(iv)(*f*) of this section may give rise to a reallocation of the adjusted tax basis of such property, or a change in the partners' relative shares of simulated depletion from such property, only to the extent permitted by section 613A(c)(7)(D) and the regulations thereunder.

(*l*) *Transfers of partnership interests.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See paragraph (b)(2)(iv)(*m*) of this section for rules concerning the effect of a section 754 election on the capital accounts of the partners.) If the transfer of an interest in a partnership causes a termination of the partnership under section 708(b)(1)(B), the capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership under §1.708–1(b)(1)(iv). Moreover, the deemed contribution of assets and liabilities by the terminated partnership to a new partnership and the deemed liquidation of the terminated partnership that occur under §1.708–1(b)(1)(iv) are disregarded for purposes of this paragraph (b)(2)(iv). See *Example 13* of paragraph (b)(5) of this section and the example in §1.708–

1(b)(1)(iv). The previous three sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(*m*) *Section 754 elections*—(*1*) *In general.* The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon adjustment to the adjusted tax basis of partnership property under section 732, 734, or 743, the capital accounts of the partners are adjusted as provided in this paragraph (b)(2)(iv)(*m*).

(*2*) *Section 743 adjustments.* In the case of a transfer of all or a part of an interest in a partnership that has a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions (see paragraph (b)(2)(iv)(*e*)(1) of this section) and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment. The preceding sentence shall not apply to the extent such basis adjustment is allocated to the common basis of partnership property under paragraph (b)(1) of §1.734–2; in these cases, such basis adjustment shall, except as provided in paragraph (b)(2)(iv)(*m*)(*5*) of this section, give rise to adjustments to the capital accounts of the partners in accordance with their interests in the partnership under paragraph (b)(3) of this section. See examples 13 (iii) and (iv) of paragraph (b)(5) of this section.

(*3*) *Section 732 adjustments.* In the case of a transfer of all or a part of an interest in a partnership that does not have a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 732(d) will be treated in the capital accounts of the partners in the same manner as section 743 basis adjustments are treated under paragraph (b)(2)(iv)(*m*)(*2*) of this section.

(*4*) Section 734 adjustments. Except as provided in paragraph (b)(2)(iv)(*m*)(*5*) of this section, in the case of a distribution of property in liquidation of a partner's interest in the partnership by a partnership that has a section 754 election in effect for the partnership taxable year in which the distribution occurs, the partner who receives the distribution that gives rise to the adjustment to the adjusted tax basis of partnership property under section 734 shall have a corresponding adjustment made to his capital account. If such distribution is made other than in liquidation of a partner's interest in the partnership, however, except as provided in paragraph (b)(2)(iv)(*m*)(*5*) of this section, the capital accounts of the partners shall be adjusted by the amount of the adjustment to the adjusted tax basis of partnership property under section 734, and such capital account adjustment shall be shared among the partners in the manner in which the unrealized income and gain that is displaced by such adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to such adjustment for its recomputed adjusted tax basis.

(*5*) *Limitations on adjustments.* Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

(*n*) *Partnership level characterization.* Except as otherwise provided in paragraph (b)(2)(iv)(k) of this section, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless adjustments to such capital accounts in respect of partnership income, gain, loss, deduction, and section 705(a)(2)(B) expenditures (or item thereof) are made with reference to the Federal tax treatment of such items (and in the case of book items, with reference to the Federal tax treatment of the corresponding tax items) at the partnership level, without regard to any requisite or elective tax treatment of such items at the partner level (for example, under section 58(i)). However, a partnership that incurs mining exploration expenditures will determine the Federal tax treatment of income, gain, loss, and deduction with respect to the property to which such expenditures relate at the partnership level only after first taking into account the elections made by its partners under section 617 and section 703(b)(4).

(*o*) *Guaranteed payments.* Guaranteed payments to a partner under section 707(c) cause the capital account of the recipient partner to be adjusted only to the extent of such partner's distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.

(*p*) *Minor discrepancies.* Discrepancies between the balances in the respective capital accounts of the partners and the balances that would be in such respective capital accounts if they had been determined and maintained in accordance with this paragraph (b)(2)(iv) will not adversely affect the validity of an allocation, provided that such discrepancies are minor and are attributable to good faith error by the partnership.

(*q*) *Adjustments where guidance is lacking.* If the rules of this paragraph (b)(2)(iv) fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership, such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that (*1*) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (*2*) is consistent with the underlying economic arrangement of the partners, and (*3*) is based, wherever practicable, on Federal tax accounting principles.

(*r*) *Restatement of capital accounts.* With respect to partnerships that began operating in a taxable year beginning before May 1, 1986, the capital accounts of the partners of which have not been determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) since inception, such capital accounts shall not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) for taxable years beginning after April 30, 1986, unless either—

(*1*) Such capital accounts are adjusted, effective for the first partnership taxable year beginning after April 30, 1986, to reflect the fair market value of partnership property as of the first day of such taxable year, and in connection with such adjustment, the rules contained in paragraph (b)(2)(iv)(*f*) (*2*), (*3*), and (*4*) of this section are satisfied, or

(*2*) The differences between the balance in each partner's capital account and the balance that would be in such partner's capital account if capital accounts had been determined and maintained in accordance with this paragraph (b)(2)(iv) throughout the full term of the partnership are not significant (for example, such differences are solely attributable to a failure to provide for treatment of section 709 expenses in accordance with the rules of paragraph (b)(2)(iv)(*i*)(*2*) of this section or to a failure to follow the rules in paragraph (b)(2)(iv)(*m*) of this section), and capital accounts are adjusted to bring them into conformity with the rules of this paragraph (b)(2)(iv) no later than the end of the first partnership taxable year beginning after April 30, 1986.

With respect to a partnership that began operating in a taxable year beginning before May 1, 1986, modifications to the partnership agreement adopted on or before November 1, 1988, to make the capital account adjustments required to comply with this paragraph, and otherwise to satisfy the requirements of this paragraph, will be treated as if such modifications were included in the partnership agreement before the end of the first partnership taxable year beginning after April 30, 1986. However, compliance with the previous sentences will have no bearing on the validity of allocations that relate to partnership taxable years beginning before May 1, 1986.

(3) *Partner's interest in the partnership*—(i) *In general.* References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. All partners' interests in the partnership are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the Internal Revenue Service by establishing facts and circumstances that show that the partners' interests in the partnership are otherwise.

(ii) *Factors considered.* In determining a partner's interest in the partnership, the following factors are among those that will be considered:

(*a*) The partners' relative contributions to the partnership,

(*b*) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

(*c*) The interests of the partners in cash flow and other non-liquidating distributions, and

(*d*) The rights of the partners to distributions of capital upon liquidation.

The provisions of this subparagraph (b)(3) are illustrated by examples (1)(i) and (ii), (4)(i), (5)(i) and (ii), (6), (7), (8), (10)(ii), (16)(i), and (19)(iii) of paragraph (b)(5) of this section. See paragraph (b)(4)(i) of this section concerning rules for determining the partners' interests in the partnership with respect to certain tax items.

(iii) *Certain determinations.* If—

(*a*) Requirements (*1*) and (*2*) of paragraph (b)(2)(ii)(*b*) of this section are satisfied, and

(*b*) All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership taxable year does not have economic effect under paragraph (b)(2)(ii) of this section.

the partners' interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (*4*), (*5*), and (*6*) of paragraph (b)(2)(ii)(*d*) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of this section. See examples 1 (iv), (v), and (vi), and 15 (ii) and (iii) of paragraph (b)(5) of this section.

(4) *Special rules*—(i) *Allocations to reflect revaluations.* If partnership property is, under paragraphs (b)(2)(iv)(*d*) or (b)(2)(iv)(*f*) of this section, properly reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from the adjusted tax basis of such property, then depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property will be greater or less than the depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property. In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to such partners (see paragraph (b)(2)(iv)(*g*) of this section), and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts. Thus, separate allocations of these tax items cannot have economic effect under paragraph (b)(2)(ii)(*b*)(*1*) of this section, and the partners' distributive shares of such tax items must (unless governed by section 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under section 704(c). See examples 14 and 18 of paragraph (b)(5) of this section.

(ii) *Credits.* Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits and tax credit recapture give rise to capital account adjustments under paragraph (b)(2)(iv)(*j*) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(*b*)(*1*) of this section, and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. With respect to the investment tax credit provided by section 38, allocations of cost or qualified investment made in accordance with paragraph (f) of §1.46–3 and paragraph (a)(4)(iv) of §1.48–8 shall be deemed to be made in accordance with the partners' interests in the partnership. With respect to other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments). See example 11 of paragraph (b)(5) of this section. Identical principles shall apply in determining the partners' interests in the partnership with respect to tax credits that arise from receipts of the partnership (whether or not taxable).

(iii) *Excess percentage depletion.* To the extent the percentage depletion in respect of an item of depletable property of the partnership exceeds the adjusted tax basis of such property, allocations of such excess percentage depletion are not reflected by adjustments to the partners' capital accounts. Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(*b*)(*1*) of this section, and such excess percentage depletion must be allocated in accordance with the partners' interests in the partnership. The partners' interests in the partnership for a partnership taxable year with respect to such excess percentage depletion shall be in the same proportion as such partners' respective distributive shares of gross income from the depletable property (as determined under section 613(c)) for such year. See example 12 of paragraph (b)(5) of this section. See paragraphs (b)(2)(iv)(*k*) and (b)(4)(v) of this section for special rules concerning oil and gas properties of the partnership.

(iv) *Allocations attributable to nonrecourse liabilities.* The rules for allocations attributable to nonrecourse liabilities are contained in § 1.704–2.

(v) *Allocations under section 613A(c)(7)(D).* Allocations of the adjusted tax basis of a partnership oil or gas property are controlled by section 613A(c)(7)(D) and the regulations thereunder. However, if the partnership agreement provides for an allocation of the adjusted tax basis of an oil or gas property among the partners, and such allocation is not otherwise governed under section 704(c) (or related principles under paragraph (b)(4)(i) of this section), that allocation will be recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), provided (*a*) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(*k*) of this section, the economic effect of which is insubstantial (as determined under paragraph (b)(2)(iii) of this section), and (*b*) all other material allocations and capital account adjustments under the partnership agreement are recognized under this paragraph (b). Otherwise, such adjusted tax basis must be allocated among the partners pursuant to section 613A(c)(7)(D) in accordance with the partners' actual interests in partnership capital or income. For purposes of section 613A(c)(7)(D) the partners' allocable shares of the amount realized upon the partnership's taxable disposition of an oil or gas property will, except to the extent governed by section 704(c) (or related principles under paragraph (b)(4)(i) of this section), be determined under this paragraph (b)(4)(v). If, pursuant to paragraph (b)(2)(iv)(*k*)(*2*) of this section, the partners' capital accounts are adjusted to reflect the simulated depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that represents recovery of its simulated adjusted tax basis therein will be allocated to the partners in the same proportion as the aggregate adjusted tax basis of such property was allocated to such partners (or their predecessors in interest). If, pursuant to paragraph (b)(2)(iv)(*k*)(*3*) of this section, the partners' capital accounts are adjusted to reflect the actual depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that equals the partners' aggregate remaining adjusted basis therein will be allocated to the partners in proportion to their respective remaining adjusted tax bases in such property. An allocation provided by the partnership agreement of the portion of the total amount realized by the partnership on its taxable disposition of an oil or gas property that exceeds the portion of the total amount realized allocated under either of the previous two sentences (whichever is applicable) shall be deemed to be made in accordance with the partners' allocable shares of such amount realized, provided (*c*) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(*k*) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(ii) of this section), and (*d*) all other allocations and capital account adjustments under the partnership agreement are recognized under this paragraph. Otherwise, the partners' allocable shares of the total amount realized by the partnership on its taxable disposition of an oil or gas property shall be determined in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. See example 19 of paragraph (b)(5) of this section. (See paragraph (b)(2)(iv)(*k*) of this section for the determination of appropriate adjustments to the partners' capital accounts relating to section 613A(c)(7)(D).)

(vi) *Amendments to partnership agreement.* If an allocation has substantial economic effect under paragraph (b)(2) of this section or is deemed to be made in accordance with the partners' interests in the partnership under paragraph (b)(4) of this section under the partnership agreement that is effective for the taxable year to which such allocation relates, and such partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the purported modification was part of the original agreement. If it is determined that the purported modification was part of the original agreement, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms. For example, if a partner is obligated by the partnership agreement to restore the deficit balance in his capital account (or any limited dollar amount thereof) in accordance with requirement (*3*) of paragraph (b)(2)(ii)(*b*) of this section and, thereafter, such obligation is eliminated or reduced (other than as provided in paragraph (b)(2)(ii)(*f*) of this section), or is not complied with in a timely manner, such elimination, reduction, or noncompliance may be treated as if it always were part of the partnership agreement for purposes of making any reallocations and determining the appropriate limitations period.

(vii) *Recapture.* For special rules applicable to the allocation of recapture income or credit, see paragraph (e) of § 1.1245–1, paragraph (f) of § 1.1250–1, paragraph (c) of § 1.1254–1, and paragraph (a) of § 1.47–6.

(5) *Examples.* The operation of the rules in this paragraph is illustrated by the following examples:

Example 1. (i) A and B form a general partnership with cash contributions of $40,000 each, which cash is used to purchase depreciable personal property at a cost of $80,000. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that A and B will have equal shares of taxable income and loss (computed without regard to cost recovery deductions) and cash flow and that all cost recovery deductions on the property will be allocated to A. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of the section, but that upon liquidation of the partnership, distributions will be made equally between the partners (regardless of capital account balances) and no partner will be required to restore the deficit balance in his capital account for distribution to partners with positive capital accounts balances. In the partnership's first taxable year, it recognizes operating income equal to its operating expenses and has an additional $20,000 cost recovery deduction, which is allocated entirely to A. That A and B will be entitled to equal distributions on liquidation, even through A is allocated the entire $20,000 cost recovery deduction, indicates A will not bear the full risk of the economic loss corresponding to such deduction if such loss occurs. Under paragraph (b)(2)(ii) of this section, the allocation lacks economic effect and will be disregarded. The partners made equal contributions to the partnership, share equally in other taxable income and loss and in cash flow, and will share equally in liquidation proceeds, indicating that their actual economic arrangement is to bear the risk imposed by the potential decrease in the value of the property equally. Thus, under paragraph (b)(3) of this section the partners' interests in the partnership are equal, and the cost recovery deduction will be reallocated equally between A and B.

(ii) Asssume the same facts as in (i) except that the partnership agreement provides that liquidation proceeds will be distributed in accordance with capital account balances if the partnership is liquidated during the first five years of its existence but that liquidation proceeds will be distributed equally if the partnership is liquidated thereafter. Since the partnership agreement does not provide for the requirement contained in paragraph (b)(2)(ii)(*b*)(*2*) of this section to be satisified throughout the term of the partnership, the partnership allocations do not have economic effect. Even if the partnership agreement provided for the requirement contained in paragraph (b)(2)(ii)(*b*)(*2*) to be satisified throughout the term of the partnership, such allocations would not have economic effect unless the requirement contained in paragraph (b)(2)(ii)(*b*)(*3*) of this section or the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section were satisfied.

(iii) Assume the same facts as in (i) except that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances throughout the term of the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(*d*) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(ii)(*d*)(*4*), (*5*), and (*6*) of this section are not reasonably expected to cause or increase a deficit balance in A's capital account.

	A	B
Capital account upon formation	$40,000	$40,000
Less: year 1 cost recovery deduction	(20,000)	0
Capital account at end of year 1	$20,000	$40,000

Under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section, the allocation of the $20,000 cost recovery deduction to A has economic effect.

(iv) Assume the same facts as in (iii) and that in the partnership's second taxable year it recognizes operating income equal to its operating expenses and has a $25,000 cost recovery deduction which, under the partnership agreement, is allocated entirely to A.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: year 2 cost recovery deduction	(25,000)	0
Capital account at end of year 2	($5,000)	$40,000

The allocation of the $25,000 cost recovery deduction to A satisfies that alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section only to the extent of $20,000. Therefore, only $20,000 of such allocation has economic effect, and the remaining $5,000 must be reallocated in accordance with the partners' interests in the partnership. Under the partnership agreement, if the property were sold immediately following the end of the partnership's second taxable year for $35,000 (its adjusted tax basis), the $35,000 would be distributed to B. Thus, B, and not A, bears the economic burden corresponding to $5,000 of the $25,000 cost recovery deduction allocated to A. Under paragraph (b)(3)(iii) of this section, $5,000 of such cost recovery deduction will be reallocated to B.

(v) Assume the same facts as in (iv) except that the cost recovery deduction for the partnershp's second taxable year is $20,000 instead of $25,000. The allocation of such cost recovery deduction to A has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section. Assume further that the property is sold for $35,000 immediately following the end of the partnership's second taxable year, resulting in a $5,000 taxable loss ($40,000 adjusted tax basis less $35,000 sales price), and the partnership is liquidated.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: year 2 cost recovery dedustion	(20,000)	0
Capital account at end of year 2	0	$40,000
Less: loss on sale	(2,500)	(2,500)
Capital account before liquidation	($2,500)	$37,500

Under the partnership agreement the $35,000 sales proceeds are distributed to B. Since B bears the entire economic burden corresponding to the $5,000 taxable loss from the sale of the property, the allocation of $2,500 of such loss to A does not have economic effect and must be reallocated in accordance with the partners' interests in the partnership. Under paragraph (b)(3)(iii) of this section, such $2,500 loss will be reallocated to B.

(vi) Assume the same facts as in (iv) except that the cost recovery deduction for the partnership's second taxable year is $20,000 instead of $25,000, and that as of the end of the partnership's second taxable year it is reasonably expected that during its third taxable year the partnership will (1) have operating income equal to its operating expenses (but will have no cost recovery deductions), (2) borrow $10,000 (recourse) and distribute such amount $5,000 to A and $5,000 to B, and (3) thereafter sell the partnership property, repay the $10,000 liability, and liquidate. In determining the extent to which the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section is satisfied as of the end of the partnership's second taxable year, the fair market value of partnership property is presumed to be equal to its adjusted tax basis (in accordance with paragraph (b)(2)(iii)(*c*) of this section). Thus, it is presumed that the selling price of such property during the partnership's third taxable year will be its $40,000 adjusted tax basis. Accordingly, there can be no reasonable expectation that there will be increases to A's capital account in the partnership's third taxable year that will offset the expected $5,000 distribution to A. Therefore, the distribution of the loan proceeds must be taken into account in determining to what extent the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) is satisfied.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: expected future distribution	(5,000)	(5,000)
Less: year 2 cost recovery deduction	(20,000)	(0)
Hypothetical capital account at end of year 2	($5,000)	$35,000

Upon sale of the partnership property, the $40,000 presumed sales proceeds would be used to repay the $10,000 liability, and the remaining $30,000 would be distributed to B. Under these circumstances the allocation of the $20,000 cost recovery deduction to A in the partnership's second taxable year satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section only to the extent of $15,000. Under paragraph (b)(3)(iii) of this section, the remaining $5,000 of such deduction will be reallocated to B. The results in this example would be the same even if the partnership agreement also provided that any gain (whether ordinary income or capital gain) upon the sale of the property would be allocated to A to the extent of the prior allocations of cost recovery deductions to him, and, at end of the partnership's second taxable year, the partners were confident that the gain on the sale of the property in the partnership's third taxable year would be sufficient to offset the expected $5,000 distribution to A.

(vii) Assume the same facts as in (iv) except that the partnership agreement also provides that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*3*) of this section). Thus, if the property were sold for $35,000 immediately after the end of the partnership's second taxable year, the $35,000 would be distributed to B, A would contribute $5,000 (the deficit balance in his capital account) to the partnership, and that $5,000 would be distributed to B. The allocation of the entire $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(viii) Assume the same facts as in (vii) except that A's obligation to restore the deficit balance in his capital account is limited to a maximum of $5,000. The allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section. At the end of such year, A makes an additional $5,000 contribution to the partnership (thereby eliminating the $5,000 deficit balance in his capital account). Under paragraph (b)(2)(ii)(*f*) of this section, A's obligation to restore up to $5,000 of the deficit balance in his capital account may be eliminated after he contributes the additional $5,000 without affecting the validity of prior allocations.

(ix) Assume the same facts as in (iv) except that upon formation of the partnership A also contributes to the partnership his negotiable promissory note with a $5,000 principal balance. The note unconditionally obligates A to pay an additional $5,000 to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(*c*) of this section, A is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect. The results in this example would be the same if (1) the note A contributed to the partnership were payable only at the end of the partnership's fourth taxable year (so that A would not be required to satisfy the note upon liquidation of his interest in the partnership), and (2) the partnership agreement provided that upon liquidation of A's interest, the partnership would retain A's note, and A would contribute to the partnership the excess of the outstanding principal balance of the note over its then fair market value.

(x) Assume the same facts as in (ix) except that A's obligation to contribute an additional $5,000 to the partnership is not evidenced by a promissory note. Instead, the partnership agreement imposes upon A the obligation to make an additional $5,000 contribution to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(*c*) of this section, as a result of A's deferred contribution requirement, A is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(*ii*)(*d*) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(xi) Assume the same facts as in (vii) except that the partnership agreement also provides that any gain (whether ordinary income or capital gain) upon the sale of the property will be allocated to A to the extent of the prior allocations to A of cost recovery deductions from such property, and additional gain will be allocated equally between A and B. At the time the allocations of cost recovery deductions were made to A, the partners believed there would be gain on the sale of the property in an amount sufficient to offset the allocations of cost recovery deductions to A. Nevertheless, the existence of the gain chargeback provision will not cause the economic effect of the allocations to be insubstantial under paragraph (b)(2)(iii)(*c*) of this section, since in testing whether the economic effect of such allocations is substantial, the recovery property is presumed to decrease in value by the amount of such deductions.

Example 2. C and D form a general partnership solely to acquire and lease machinery that is 5-year recovery property under section 168. Each contributes $100,000, and the partnership obtains an $800,000 recourse loan to purchase the machinery. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such machinery. The partnership, C, and D have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section). The partnership agreement further provides that (a) partnership net taxable loss will be allocated 90 percent to C and 10 percent to D until such time as there is partnership net taxable income, and therefore C will be allocated 90 percent of such taxable income until he has been allocated partnership net taxable income equal to the partnership net taxable loss previously allocated to him, (b) all further partnership net taxable income or loss will be allocated equally between C and D, and (c) distributions of operating cash flow will be made equally between C and D. The partnership enters into a 12-year lease with a financially secure corporation under which the partnership expects to have a net taxable loss in each of its first 5 partnership taxable years due to cost recovery deductions with respect to the machinery and net taxable income in each of its following 7 partnership taxable years, in part due to the absence of such cost recovery deductions. There is a strong likelihood that the partnership's net taxable loss in partnership taxable years 1 through 5 will be $100,000, $90,000, $80,000, $70,000, and $60,000, respectively, and the partnership's net taxable income in partnership taxable years 6 through 12 will be $40,000, $50,000, $60,000, $70,000, $80,000, $90,000, and $100,000, respectively. Even though there is a strong likelihood that the allocations of net taxable loss in years 1 through 5 will be largely offset by other allocations in partnership taxable years 6 through 12, and even if it is assumed that the total tax liability of the partners in years 1 through 12 will be less than if the allocations had not been provided in the partnership agreement, the economic effect of the allocations will not be insubstantial under paragraph (b)(2)(iii)(*c*) of this section. This is because at the time such allocations became part of the partnership agreement, there was a strong likelihood that the allocations of net taxable loss in years 1 through 5 would not be largely offset by allocations of income within 5 years (determined on a first-in, first-out basis). The year 1 allocation will not be offset until years 6, 7, and 8, the year 2 allocation will not be offset until years 8 and 9, the year 3 allocation will not be offset until years 9 and 10, the year 4 allocation will not be offset until years 10 and 11, and the year 5 allocation will not be offset until years 11 and 12.

Example 3. E and F enter into a partnership agreement to develop and market experimental electronic devices. E contributes $2,500 cash and agrees to devote his full-time services to the partnership. F contributes $100,000 cash and agrees to obtain a loan for the partnership for any additional capital needs. The partnership agreement provides that all deductions for research and experimental expenditures and interest on partnership loans are to be allocated to F. In addition, F will be allocated 90 percent, and E 10 percent, of partnership taxable income or loss, computed net of the deductions for such research and experimental expenditures and interest, until F has received allocations of such taxable income equal to the sum of such research and experimental expenditures, such interest expense, and his share of such taxable loss. Thereafter, E and F will share all taxable income and loss equally. Operating cash flow will be distributed equally between E and F. The partnership agreement also provides that E's and F's capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section). These allocations have economic effect. In addition, in view of the nature of the partnership's activities, there is not a strong likelihood at the time the allocations become part of the partnership agreement that the economic effect of the allocations to F of deductions for research and experimental expenditures and interest on partnership loans will be largely offset by allocations to F of partnership net taxable income. The economic effect of the allocations is substantial.

Example 4. (i) G and H contribute $75,000 and $25,000, respectively, in forming a general partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated equally between the partners, that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, but that all partnership distributions will, regardless of capital account balances, be made 75 percent to G and 25 percent to H. Following the liquidation of the partnership, neither partner is required to restore the deficit balance in his capital account to the partnership for distribution to partners with positive capital account balances. The allocations in the partnership agreement do not have economic effect.

Since contributions were made in a 75/25 ratio and the partnership agreement indicates that all economic profits and losses of the partnership are to be shared in a 75/25 ratio, under paragraph (b)(3) of this section, partnership income, gain, loss, and deduction will be reallocated 75 percent to G and 25 percent to H.

(ii) Assume the same facts as in (i) except that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75 percent to G and 25 percent to H. G and H are ultimately liable (under a State law right of contribution) for 75 percent and 25 percent, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(*b*) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(*i*) of this section.

(iii) Assume the same facts as in (i) except that the partnership agreement provides that any partner with a deficit balance in his capital account must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section). Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(*b*) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(*i*) of this section.

Example 5. (i) Individuals I and J are the only partners of an investment partnership. The partnership owns corporate stocks, corporate debt instruments, and tax-exempt debt instruments. Over the next several years, I expects to be in the 50 percent marginal tax bracket, and J expects to be in the 15 percent marginal tax bracket. There is a strong likelihood that in each of the next several years the partnership will realize between $450 and $550 of tax-exempt interest and between $450 and $550 of a combination of taxable interest and dividends from its investments. I and J made equal capital contributions to the partnership, and they have agreed to share equally in gains and losses from the sale of the partnership's investment securities. I and J agree, however, that rather than share interest and dividends of the partnership equally, they will allocate the partnership's tax-exempt interest 80 percent to I and 20 percent to J and will distribute cash derived from interest received on the tax-exempt bonds in the same percentages. In addition, they agree to allocate 100 percent of the partnership's taxable interest and dividends to J and to distribute cash derived from interest and dividends received on the corporate stocks and debt instruments 100 percent to J. The partnership agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The allocation of taxable interest and dividends and tax-exempt interest has economic effect, but that economic effect is not substantial under the general rules set forth in paragraph (b)(2)(iii) of this section. Without the allocation I would be allocated between $225 and $275 of tax-exempt interest and between $225 and $275 of a combination of taxable interest and dividends, which (net of Federal income taxes he would owe on such income) would give I between $337.50 and $412.50 after tax. With the allocation, however, I will be allocated between $360 and $440 of tax-exempt interest and no taxable interest and dividends, which (net of Federal income taxes) will give I between $360 and $440 after tax. Thus, at the time the allocations became part of the partnership agreement, I is expected to enhance his after-tax economic consequences as a result of the allocations. On the other hand, there is a strong likelihood that neither I nor J will substantially diminish his after-tax economic consequences as a result of the allocations. Under the combination of likely investment outcomes least favorable for J, the partnership would realize $550 of tax-exempt interest and $450 of taxable interest and dividends, giving J $492.50 after tax (which is more than the $466.25 after tax J would have received if each of such amounts had been allocated equally between the partners). Under the combination of likely investment outcomes least favorable for I, the partnership would realize $450 of tax-exempt interest and $550 of taxable interest and dividends, giving I $360 after tax (which is not substantially less than the $362.50 he would have received if each of such amounts had been allocated equally between the partners). Accordingly, the allocations in the partnership agreement must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i). In addition, assume that in the first partnership taxable year in which the allocation arrangement described in (i) applies, the partnership realizes $450 of tax-exempt interest and $550 of taxable interest and dividends, so that, pursuant to the partnership agreement, I's capital account is credited with $360 (80 percent of the tax-exempt interest), and J's capital account is credited with $640 (20 percent of the tax-exempt interest and 100 percent of the taxable interest and dividends). The allocations of tax-exempt interest and taxable interest and dividends (which do not have substantial economic effect for the reasons stated in (i) will be disregarded and will be reallocated. Since under the partnership agreement I will receive 36 percent (360/1,000) and J will receive 64 percent (640/1,000) of the partnership's total investment income in such year, under paragraph (b)(3) of this section the partnership's tax-exempt interest and taxable interest and dividends each will be reallocated 36 percent to I and 64 percent to J.

Example 6. K and L are equal partners in a general partnership formed to acquire and operate property described in section 1231(b). The partnership, K, and L have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section). For a taxable year in which the partnership expects to incur a loss on the sale of a portion of such property, the partnership agreement is amended (at the beginning of the taxable year) to allocate such loss to K, who expects to have no gains from the sale of depreciable property described in section 1231(b) in that taxable year, and to allocate an equivalent amount of partnership loss and deduction for that year of a different character to L, who expects to have such gains. Any partnership loss and deduction in excess of these allocations will be allocated equally between K and L. The amendment is effective only for that taxable year. At the time the partnership agreement is amended, there is a strong likelihood that the partnership will incur deduction or loss in the taxable year other than loss from the sale of property described in section 1231(b) in an amount that will substantially equal or exceed the expected amount of the section 1231(b) loss. The allocations in such taxable year have economic effect. However, the economic effect of the allocations is insubstantial under the test described in paragraph (b)(2)(iii) (*b*) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that the net increases and decreases to K's and L's capital accounts will be the same at the end of the taxable year to which they apply with such allocations in effect as they would have been in the absence of such allocations, and that the total taxes of K and L for such year will be reduced as a result of such allocations. If in fact the partnership incurs deduction or loss, other than loss from the sale of property described in section 1231(b), in an amount at least equal to the section 1231(b) loss, the loss and deduction in such taxable year will be reallocated equally between K and L under paragraph (b)(3) of this section. If not, the loss from the sale of property described in section 1231(b) and the items of deduction and other loss realized in such year will be reallocated between K and L in proportion to the net decreases in their capital accounts due to the allocation of such items under the partnership agreement.

Example 7. (i) M and N are partners in the MN general partnership, which is engaged in an active business. Income, gain, loss, and deduction from MN's business is allocated equally between M and N. The partnership, M, and N have calendar taxable years. Under the partnership agreement the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). In order to enhance the credit standing of the partnership, the partners contribute surplus funds to the partnership, which the partners agree to invest in equal dollar amounts of tax-exempt bonds and corporate stock for the partnership's first 3 taxable years. M is expected to be in a higher marginal tax bracket than N during those 3 years. At the time the decision to make these investments is made, it is agreed that, during the 3-year period of the investment, M will be allocated 90 percent and N 10 percent of the interest income from the tax-exempt bonds as well as any gain or loss from the sale thereof, and that M will be allocated 10 percent and N 90 percent of the dividend income from the corporate stock as well as any gain or loss from the sale thereof. At the time the allocations concerning the investments become part of the partnership agreement, there is not a strong likelihood that the gain or loss from the sale of the stock will be substantially equal to the gain or loss from the sale of the tax-exempt bonds, but there is a strong likelihood that the tax-exempt interest and the taxable dividends realized from these investments during the 3-year period will not differ substantially. These allocations have economic effect, and the economic effect of the allocations of the gain or loss on the sale of the tax-exempt bonds and corporate stock is substantial. The economic effect of the allocations of the tax-exempt interest and the taxable dividends, however, is not substantial under the test described in paragraph (b)(2)(iii)(*c*) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that at the end of the 3-year period to which such allocations relate, the net increases and decreases to M's and N's capital accounts will be the same with such allocations as they would have been in the absence of such allocations, and that the total taxes of M and N for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the amounts of the tax-exempt interest and taxable dividends earned by the partnership during the 3-year period are equal, the tax-exempt interest and taxable dividends will be reallocated to the partners in equal shares under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts during such 3-year period due to the allocation of such items under the partnership agreement.

(ii) Assume the same facts as in (i) except that gain or loss from the sale of the tax-exempt bonds and corporate stock will be allocated equally between M and N and the partnership agreement provides that the 90/10 allocation arrangement with respect to the investment income applies only to the first $10,000 of interest income from the tax-exempt bonds and the first $10,000 of dividend income from the corporate stock, and only to the first taxable year of the partnership. There is a strong likelihood at the time the 90/10 allocation of the investment income became part of the partnership agreement that in the first taxable year of the partnership, the partnership will earn more than $10,000 of tax-exempt interest and more than $10,000 of taxable dividends. The allocations of tax-exempt interest and taxable dividends provided in the partnership agreement have economic effect, but under the test contained in paragraph (b)(2)(iii)(*b*) of this section, such economic effect is not substantial for the same reasons stated in (i) (but applied to the 1 taxable year, rather than to a 3-year period). If in fact the partnership realizes at least $10,000 of tax-exempt interest and at least $10,000 of taxable dividends in such year, the allocations of such interest income and dividend income will be reallocated equally between M and N under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts due to the allocations of such items under the partnership agreement.

(iii) Assume the same facts as in (ii) except that at the time the 90/10 allocation of investment income becomes part of the partnership agreement, there is not a strong likelihood that (1) the partnership will earn $10,000 or more of tax-exempt interest and $10,000 or more of taxable dividends in the partnership's first taxable year, and (2) the amount of tax-exempt interest and taxable dividends earned during such year will be substantially the same. Under these facts the economic effect of the allocations generally will be substantial. (Additional facts may exist in certain cases, however, so that the allocation is insubstantial under the second sentence of paragraph (b)(2)(iii). See example 5 above.)

Example 8. (i) O and P are equal partners in the OP general partnership. The partnership, O, and P have calendar taxable years. Partner O has a net operating loss carryover from another venture that is due to expire at the end of the partnership's second taxable year. Otherwise, both partners expect to be in the 50 percent marginal tax bracket in the next several taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership agreement is amended (at the beginning of the partnership's second taxable year) to allocate all the partnership net taxable income for that year to O. Future partnership net taxable loss is to be allocated to O, and future partnership net taxable income to P, until the allocation of income to O in the partnership's second taxable year is offset. It is further agreed orally that in the event the partnership is liquidated prior to completion of such offset, O's capital account will be adjusted downward to the extent of one-half of the allocations of income to O in the partnership's second taxable year that have not been offset by other allocations, P's capital account will be adjusted upward by a like amount, and liquidation proceeds will be distributed in accordance with the partners' adjusted capital account balances. As a result of this oral amendment, all allocations of partnership net taxable income and net taxable loss made pursuant to the amendment executed at the beginning of the partnership's second taxable year lack economic effect and will be disregarded. Under the partnership agreement other allocations are made equally to O and P, and O and P will share equally in liquidation proceeds, indicating that the partners' interests in the partnership are equal. Thus, the disregarded allocations will be reallocated equally between the partners under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i) except that there is no agreement that O's and P's capital accounts will be adjusted downward and upward, respectively, to the extent of one-half of the partnership net taxable income allocated to O in the partnership's second taxable year that is not offset subsequently by other allocations. The income of the partnership is generated primarily by fixed interest payments received with respect to highly rated corporate bonds, which are expected to produce sufficient net taxable income prior to the end of the partnership's seventh taxable year to offset in large part the net taxable income to be allocated to O in the partnership's second taxable year. Thus, at the time the allocations are made part of the partnership agreement, there is a strong likelihood that the allocation of net taxable income to be made to O in the second taxable year will be offset in large part within 5 taxable years thereafter. These allocations have economic effect. However, the economic effect of the allocation of partnership net taxable income to O in the partnership's second taxable year, as well as the offsetting allocations to P, is not substantial under the test contained in paragraph (b)(2)(iii)(*c*) of this section because there is a strong likelihood that the net increases or decreases in O's and P's capital accounts will be the same at the end of the partnership's seventh taxable year with such allocations as they would have been in the absence of such allocations, and the total taxes of O and P for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the partnership, in its taxable years 3 through 7, realizes sufficient net taxable income to offset the amount allocated to O in the second taxable year, the allocations provided in the partnership agreement will be reallocated equally between the partners under paragraph (b)(3) of this section.

Example 9. Q and R form a limited partnership with contributions of $20,000 and $180,000, respectively. Q, the limited partner, is a corporation that has $2,000,000 of net operating loss carryforwards that will not expire for 8 years. Q does not expect to have sufficient income (apart from the income of the partnership) to absorb any of such net operating loss carryforwards. R, the general partner, is a corporation that expects to be in the 46 percent marginal tax bracket for several years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership's cash, together with the proceeds of an $800,000 loan, are invested in assets that are expected to produce taxable income and cash flow (before debt service) of approximately $150,000 a year for the first 8 years of the partnership's operations. In addition, it is expected that the partnership's total taxable income in its first 8 taxable years will not exceed $2,000,000. The partnership's $150,000 of cash flow in each of its first 8 years will be used to retire the $800,000 loan. The partnership agreement provides that partnership net taxable income will be allocated 90 percent to Q and 10 percent to R in the first through eighth partnership taxable years, and 90 percent to R and 10 percent to Q in all subsequent partnership taxable years. Net taxable loss will be allocated 90 percent to R and 10 percent to Q in all partnership taxable years. All distributions of cash from the partnership to partners (other than the priority distributions to Q described below) will be made 90 percent to R and 10 percent to Q. At the end of the partnership's eighth taxable year, the amount of Q's capital account in excess of one-ninth of R's capital account on such date will be designated as Q's ''excess capital account.'' Beginning in the ninth taxable year of the partnership, the undistributed portion of Q's excess capital account will begin to bear interest (which will be paid and deducted under section 707(c) at a rate of interest below the rate that the partnership can borrow from commercial lenders, and over the next several years (following the eight year) the partnership will make priority cash distributions to Q in prearranged percentages of Q's excess capital account designed to amortize Q's excess capital account and the interest thereon over a prearranged period. In addition, the partnership's agreement prevents Q from causing his interest in the partnership from being liquidated (and thereby receiving the balance in his capital account) without R's consent until Q's excess capital account has been eliminated. The below market rate of interest and the period over which the amortization will take place are prescribed such that, as of the end of the partnership's eighth taxable year, the present value of Q's right to receive such priority distributions is approximately 46 percent of the amount of Q's excess capital account as of such date. However, because the partnership's income for its first 8 taxable years will be realized approximately ratably over that period, the present value of Q's right to receive the priority distributions with respect to its excess capital account is, as of the date the partnership agreement is entered into, less than the present value of the additional Federal income taxes for which R would be liable if, during the partnership's first 8 taxable years, all partnership income were to be allocated 90 percent to R and 10 to Q. The allocations of partnership taxable income to Q and R in the first through eighth partnership taxable years have economic effect. However, such economic effect is not substantial under the general rules set forth in paragraph (b)(2)(iii) of this section. This is true because R may enhance his after-tax economic consequences, on a present value basis, as a result of the allocations to Q of 90 percent of partnership's income during taxable years 1 through 8, and there is a strong likelihood that neither R nor Q will substantially diminish its after-tax economic consequences, on a present value basis, as a result of such allocation. Accordingly, partnership taxable income for partnership taxable years 1 through 8 will be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

Example 10. (i) S and T form a general partnership to operate a travel agency. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership agreement provides that T, a resident of a foreign country, will be allocated 90 percent, and S 10 percent, of the income, gain, loss, and deduction derived from operations conducted by T within his country, and all remaining income, gain, loss, and deduction will be allocated equally. The amount of such income, gain, loss, or deduction cannot be predicted with any reasonable certainty. The allocations provided by the partnership agreement have substantial economic effect.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all income, gain, loss, and deduction of the partnership will be shared equally, but that T will be allocated all income, gain, loss, and deduction derived from operations conducted by him within his country as a part of his equal share of partnership income, gain, loss, and deduction, upon to the amount of such share. Assume the total tax liability of S and T for each year to which these allocations relate will be reduced as a result of such allocation. These allocations have economic effect. However, such economic effect is not substantial under the test stated in paragraph (b)(2)(iii)(*b*) of this section because, at the time the allocations became part of the partnership agreement, there is a strong likelihood that the net increases and decreases to S's and T's capital accounts will be the same at the end of each partnership taxable year with such allocations as they would have been in the absence of such allocations, and that the total tax liability of S and T for each year to which such allocations relate will be reduced as a result of such allocations. Thus, all items of partnership income, gain, loss, and income, gain, loss, and deduction will be reallocated equally between S and T under paragraph (b)(3) of this section.

Example 11. (i) U and V share equally all income, gain, loss, and deduction of the UV general partnership, as well as all non-liquidating distributions made by the partnership. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The agreement further provides that the partners will be allocated equal shares of any section 705(a)(2)(B) expenditures of the partnership. In the partnership's first taxable year, it pays qualified first-year wages of $6,000 and is entitled to a $3,000 targeted jobs tax credit under sections 44B and 51 of the Code. Under section 280C the partnership must reduce its deduction for wages paid by the $3,000 credit claimed (which amount constitutes a section 705(a)(2)(B) expenditure). The partnership agreement allocates the credit to U. Although the allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect, the allocation of tax credit cannot have economic effect since it cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section. Under that rule, since the expenses that gave rise to the credit are shared equally by the partners, the credit will be shared equally between U and V.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, the partnership agreement is amended to allocate to U all wage expenses incurred in that year (including wage expenses that constitute section 705(a)(2)(B) expenditures) whether or not such wages qualify for the credit. The partnership agreement contains no offsetting allocations. That taxable year the partnership pays $8,000 in total wages to its employees. Assume that the partnership has operating income equal to its operating expenses (exclusive of expenses for wages). Assume further that $6,000 of the $8,000 wage expense constitutes qualified first-year wages. U is allocated the $3,000 deduction and the $3,000 section 705(a)(2)(B) expenditure attributable to the $6,000 of qualified first-year wages, as well as the deduction for the other $2,000 in wage expenses. The allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect. Furthermore, since the wage credit is allocated in the same proportion as the expenses that gave rise to the credit, and the allocation of those expenses has substantial economic effect, the allocation of such credit to U is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section and is recognized thereunder.

Example 12. (i) W and X form a general partnership for the purpose of mining iron ore. W makes an initial contribution of $75,000, and X makes an initial contribution of $25,000. The partnership agreement provides that non-liquidating distributions will be made 75 percent to W and 25 percent to X, and that all items of income, gain, loss, and deduction will be allocated 75 percent to W and 25 percent to X, except that all percentage depletion deductions will be allocated to W. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraphs (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). Assume that the adjusted tax basis of the partnership's only depletable iron ore property is $1,000 and that the percentage depletion deduction for the taxable year with respect to such property is $1,500. The allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the allocation of $1,000 of the percentage depletion deduction have substantial economic effect. The allocation to W of the remaining $500 of the percentage depletion deduction, representing the excess of percentage depletion over adjusted tax basis of the iron ore property, cannot have economic effect since such amount cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation to W of that $500 excess percentage depletion deduction is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section, under which such $500 excess depletion deduction (and all further percentage depletion deductions from the mine) will be reallocated 75 percent to W and 25 percent to X.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all percentage depletion deductions of the partnership will be allocated 75 percent to W and 25 percent to X. Once again, the allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the allocation of $1,000 of the percentage depletion deduction have substantial economic effect. Furthermore, since the $500 portion of the percentage depletion deduction that exceeds the adjusted basis of such iron ore property is allocated in the same manner as valid allocations of the gross income from such property during the taxable year (*i.e.*, 75 percent to W and 25 percent to X), the allocation of the $500 excess percentage depletion contained in the partnership agreement is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section.

Example 13. (i) Y and Z form a brokerage general partnership for the purpose of investing and trading in marketable securities. Y contributes cash of $10,000, and Z contributes securities of P corporation, which have an adjusted basis of $3,000 and a fair market value of $10,000. The partnership would not be an investment company under section 351(e) if it were incorporated. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). The partnership uses the interim closing of the books method for purposes of section 706. The initial capital accounts of Y and Z are fixed at $10,000 each. The agreement further provides that all partnership distributions, income, gain, loss, deduction, and credit will be shared equally between Y and Z, except that the taxable gain attributable to the precontribution appreciation in the value of the securities of P corporation will be allocated to Z in accordance with section 704(c). During the partnership's first taxable year, it sells the securities of P corporation for $12,000, resulting in a $2,000 book gain ($12,000 less $10,000 book value) and a $9,000 taxable gain ($12,000 less $3,000 adjusted tax basis). The partnership has no other income, gain, loss, or deductions for the taxable year. The gain from the sale of the securities is allocated as follows:

	Y		Z	
	Tax	Book	Tax	Book
Capital account upon formation	$10,000	$10,000	$3,000	$10,000

	Y		Z	
	Tax	Book	Tax	Book
Plus: gain	1,000	1,000	8,000	1,000
Capital account at end of year 1 ..	$11,000	$11,000	$11,000	$11,000

The allocation of the $2,000 book gain, $1,000 each to Y and Z, has substantial economic effect. Furthermore, under section 704(c) the partners' distributive shares of the $9,000 taxable gain are $1,000 to Y and $8,000 to Z.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, it invests its $22,000 of cash in securities of G Corp. The G Corp. securities increase in value to $40,000, at which time Y sells 50 percent of his partnership interest (*i.e.*, a 25 percent interest in the partnership) to LK for $10,000. The partnership does not have a section 754 election in effect for the partnership taxable year during which such sale occurs. In accordance with paragraph (b)(2)(iv)(*l*) of this section, the partnership agreement provides that LK inherits 50 percent of Y's $11,000 capital account balance. Thus, following the sale, LK and Y each have a capital account of $5,500, and Z's capital account remains at $11,000. Prior to the end of the partnership's second taxable year, the securities are sold for their $40,000 fair market value, resulting in an $18,000 taxable gain ($40,000 less $22,000 adjusted tax basis). The partnership has no other income, gain, loss, or deduction in such taxable year. Under the partnership agreement the $18,000 taxable gain is allocated as follows:

	Y	Z	LK
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	4,500	9,000	4,500
Capital account at end of year 2	$10,000	$20,000	$10,000

The allocation of the $18,000 taxable gain has substantial economic effect.

(iii) Assume the same facts as in (ii) except that the partnership has a section 754 election in effect for the partnership taxable year during which Y sells 50 percent of his interest to LK. Accordingly, under § 1.743–1 there is a $4,500 basis increase to the G Corp. securities with respect to LK. Notwithstanding this basis adjustment, as a result of the sale of the G Corp. securities, LK's capital account is, as in (ii), increased by $4,500. The fact that LK recognizes no taxable gain from such sale (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(*m*)(*2*) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(iv) Assume the same facts as in (iii) except that immediately following Y's sale of 50 percent of this interest to LK, the G Corp. securities decrease in value to $32,000 and are sold. The $10,000 taxable gain ($32,000 less $22,000 adjusted tax basis) is allocated as follows:

	Y	Z	LK
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	2,500	5,000	2,500
Capital account at end of the year 2 ..	$8,000	$16,000	$8,000

The fact that LK recognizes a $2,000 taxable loss from the sale of the G Corp. securities (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(*m*)(*2*) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(v) Assume the same facts as in (ii) except that Y sells 100 percent of his partnership interest (*i.e.*, a 50 percent interest in the partnership) to LK for $20,000. Under section 708(b)(1)(B) the partnership terminates. Under paragraph (b)(1)(iv) of § 1.708–1, there is a constructive liquidation of the partnership. Immediately preceding the constructive liquidation, the capital accounts of Z and LK equal $11,000 each (LK having inherited Y's $11,000 capital account) and the book value of the G Corp. securities is $22,000 (original purchase price of securities). Under paragraph (b)(2)(iv)(*l*) of this section, the deemed contribution of assets and liabilities by the terminated partnership to the new partnership and the deemed liquidation of the terminated partnership that occur under § 1.708–1(b)(1)(iv) in connection with the constructive liquidation of the terminated partnership are disregarded in the maintenance and computation of the partners' capital accounts. As a result, the capital accounts of Z and LK in the new partnership equal $11,000 each (their capital accounts in the terminated partnership immediately prior to the termination), and the book value of the G Corp. securities remains $22,000 (its book value immediately prior to the termination). This *Example 13*(v) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this *Example 13*(v) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this *Example 13*(v) to the termination in a consistent manner.

Example 14. (i) MC and RW form a general partnership to which each contributes

$10,000. The $20,000 is invested in securities of Ventureco (which are not readily tradable on an established securities market). In each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding gain or loss from the sale of securities). The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(*b*)(*2*) and (*3*) of this section). The partnership uses the interim closing of the books method for purposes of section 706. Assume that the Ventureco securities subsequently appreciate in value to $50,000. At that time SK makes a $25,000 cash contribution to the partnership (thereby acquiring a one-third interest in the partnership), and the $25,000 is placed in a bank account. Upon SK's admission to the partnership, the capital accounts of MC and RW (which were $10,000 each prior to SK's admission) are, in accordance with paragraph (b)(2)(iv)(*f*) of this section, adjusted upward (to $25,000 each) to reflect their shares of the unrealized appreciation in the Ventureco securities that occurred before SK was admitted to the partnership. Immediately after SK's admission to the partnership, the securities are sold for their $50,000 fair market value, resulting in taxable gain of $30,000 ($50,000 less $20,000 adjusted tax basis) and no book gain or loss. An allocation of the $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $30,000 taxable gain will, in accordance with section 704(c) principles, be shared $15,000 to MC and $15,000 to RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	15,000	0	15,000	0	0	0
Capital account following sale	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000

(ii) Assume the same facts as (i), except that after SK's admission to the partnership, the Ventureco securities appreciate in value to $74,000 and are sold, resulting in taxable gain of $54,000 ($74,000 less $20,000 adjusted tax basis) and book gain of $24,000 ($74,000 less $50,000 book value). Under the partnership agreement the $24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $54,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the taxable gain will, in accordance with section 704(c) principles, be shared $23,000 to MC $23,000 to RW, and $8,000 to SK, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	23,000	8,000	23,000	8,000	8,000	8,000
Capital account following sale	$33,000	$33,000	$33,000	$33,000	$33,000	$33,000

(iii) Assume the same facts as (i) except that after SK's admission to the partnership, the Ventureco securities depreciate in value to $44,000 and are sold, resulting in taxable gain of $24,000 ($44,000 less $20,000 adjusted tax basis) and a book loss of $6,000 ($50,000 book value less $44,000). Under the partnership agreement the $6,000 book loss is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $24,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $24,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between MC and RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	12,000	0	12,000	0	0	0
Less: loss	0	(2,000)	0	(2,000)	0	(2,000)
Capital account following sale	$22,000	$23,000	$22,000	$23,000	$25,000	$25,000

That SK bears an economic loss of $2,000 without a corresponding taxable loss is attributable entirely to the ''ceiling rule.'' See paragraph (c)(2) of § 1.704–1.

(iv) Assume the same facts as in (ii) except that upon the admission of SK the capital accounts of MC and RW are not each adjusted upward from $10,000 to $25,000 to reflect the appreciation in the partnership's securities that occurred before SK was admitted to the partnership. Rather, upon SK's admission to the partnership, the partnership agreement is amended to provide that the first $30,000 of taxable gain upon the sale of such securities will be allocated equally between MC and RW, and that all other income, gain, loss, and deduction will be allocated equally between MC, RW, and SK. When the securities are sold for $74,000, the $54,000 of taxable gain is so allocated. These allocations of taxable gain have substantial economic effect. (If the agreement instead provides for all taxable gain (including the $30,000 taxable gain attributable to the appreciation in the securities prior to SK's admission to the partnership) to be allocated equally between MC, RW, and SK, the partners should consider whether, and to what extent, the provisions of paragraphs (b)(1)(iii) and (iv) of this section are applicable.)

(v) Assume the same facts as in (iv) except that instead of selling the securities, the partnership makes a distribution of the securities (which have a fair market value of $74,000). Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). In accordance with paragraph (b)(2)(iv)(*e*) of this section, the partners' capital accounts are adjusted immediately prior to the distribution to reflect how taxable gain ($54,000) would have been allocated had the securities been sold for their $74,000 fair market value, and capital account adjustments in respect of the distribution of the securities are made with reference to the $74,000 ''booked-up'' fair market value.

	MC	RW	SK
Capital account before adjustment	$10,000	$10,000	$25,000
Deemed sale adjustment	23,000	23,000	8,000
Less: distribution	(24,667)	(24,667)	(24,667)
Capital account after distribution	$8,333	$8,333	$8,333

(vi) Assume the same facts as in (i) except that the partnership does not sell the Ventureco securities. During the next 3 years the fair market value of the Ventureco securities remains at $50,000, and the partnership engages in no other investment activities. Thus, at the end of that period the balance sheet of the partnership and the partners' capital accounts are the same as they were at the beginning of such period. At the end of the 3 years, MC's interest in the partnership is liquidated for the $25,000 cash held by the partnership. Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). Assume further that the partnership has a section 754 election in effect for the taxable year during which such liquidation occurs. Under sections 734(b) and 755 the partnership increases the basis of the Ventureco securities by the $15,000 basis adjustment (the excess of $25,000 over the $10,000 adjusted tax basis of MC's partnership interest).

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: basis adjustment	15,000	0	0	0	0	0
Less: distribution	(25,000)	(25,000)	0	0	0	0
Capital account account after liquidation	0	0	$10,000	$25,000	$25,000	$25,000

(vii) Assume the same facts as in (vi) except that the partnership has no section 754 election in effect for the taxable year during which such liquidation occurs.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Less: distribution	(25,000)	(25,000)	0	0	0	0
Capital account after liquidation	($15,000)	0	$10,000	$25,000	$25,000	$25,000

Following the liquidation of MC's interest in the partnership, the Ventureco securities are sold for their $50,000 fair market value, resulting in no book gain or loss but a $30,000 taxable gain. An allocation of this $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(*f*) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that $15,000 of such taxable gain will, in accordance with section 704(c) principles, be included in RW's distributive share, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section. The remaining $15,000 of such gain will, under paragraph (b)(3) of this section, be shared equally between RW and SK.

Example 15. (i) JB and DK form a limited partnership for the purpose of purchasing residential real estate to lease. JB, the limited partner, contributes $13,500, and DK, the general partner, contributes $1,500. The partnership, which uses the cash receipts and disbursements method of accounting, purchases a building for $100,000 (on leased land), incurring a recourse mortgage of $85,000 that requires the payment of interest only for a period of 3 years. The partnership agreement provides that partnership net taxable income and loss will be allocated 90 percent to JB and 10 percent to DK, the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section), and JB is not required to restore any deficit balance in his capital account, but DK is so required. The partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(*d*) of this section). As of the end of each of the partnership's first 3 taxable years, the items described in paragraphs (b)(2)(ii)(*d*)(*4*), (*5*), and (*6*) of this section are not reasonably expected to cause or increase a deficit balance in JB's capital account. In the partnership's first taxable year, it has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership's first taxable year.

	JB	DK
Capital account upon formation	$13,500	$1,500
Less: year 1 net loss	(10,800)	(1,200)
Capital account at end of year 1	$2,700	$300

The alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section is satisfied as of the end of the partnership's first taxable year. Thus, the allocation made in the partnership's first taxable year has economic effect.

(ii) Assume the same facts as in (i) and that in the partnership's second taxable year it again has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership's second taxable year.

	JB	DK
Capital account at beginning of year 1	$2,700	$300
Less: year 2 net loss	(10,800)	(1,200)
Capital account at end of year 2	($8,100)	($900)

Only $2,700 of the $10,800 net taxable loss allocated to JB satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(*d*) of this section as of the end of the partnership's second taxable year. The allocation of such $2,700 net taxable loss to JB (consisting of $2,250 of rental income, $450 of operating expenses, $1,800 of interest expense, and $2,700 of cost recovery deductions) has economic effect. The remaining $8,100 of net taxable loss allocated by the partnership agreement to JB must be reallocated in accordance with the partners' interests in the partnership. Under paragraph (b)(3)(iii) of this section, the determination of the partners' interests in the remaining $8,100 net taxable loss is made by comparing how distributions (and contributions) would be made if the partnership sold its property at its adjusted tax basis and liquidated immediately following the end of the partnership's first taxable year with the results of such a sale and liquidation immediately following the end of the partnership's second taxable year. If the partnership's real property were sold for its $88,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's first taxable year, the $88,000 sales proceeds would be used to repay the $85,000 note, and there would be $3,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $300 and $2,700, respectively. If such property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining in the partnership to distribute. A comparison of these outcomes indicates that JB bore $2,700 and DK $9,300 of the economic burden that corresponds to the $12,000 net taxable loss. Thus, in addition to the $1,200 net taxable loss allocated to DK under the partnership agreement, $8,100 of net taxable loss will be reallocated to DK under paragraph (b)(3)(iii) of this section. Similarly, for subsequent taxable years, absent an increase in JB's capital account, all net taxable loss allocated to JB under the partnership agreement will be reallocated to DK.

(iii) Assume the same facts as in (ii) and that in the partnership's third taxable year there is rental income of $35,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $10,000. The capital accounts of the partners maintained on the books of the partnership do not take into account the reallocation to DK of the $8,100 net taxable loss in the partnership's second taxable year. Thus, an allocation of the $15,000 net taxable income $13,500 to JB and $1,500 to DK (as dictated by the partnership agreement and as reflected in the capital accounts of the partners) does not have economic effect. The partners' interests in the partnership with respect to such $15,000 taxable gain again is made in the manner described in paragraph (b) (3) (iii) of this section. If the partnership's real property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining to distribute. If such property were sold for its $66,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's third taxable year, the $91,000 ($66,000 sales proceeds plus $25,000 cash on hand) would be used to repay the $85,000 note and there would be $6,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $600 and $5,400, respectively. Accordingly, under paragraph (b) (3) (iii) of this section the $15,000 net taxable income in the partnership's third taxable year will be reallocated $9,600 to DK (minus $9,000 at end of the second taxable year to positive $600 at end of the third taxable year) and $5,400 to JB (zero at end of the second taxable year to positive $5,400 at end of the third taxable year).

Example 16. (i) KG and WN form a limited partnership for the purpose of investing in improved real estate. KG, the general partner, contributes $10,000 to the partnership, and WN, the limited partner, contributes $990,000 to the partnership. The $1,000,000 is used to purchase an apartment building on leased land. The partnership agreement provides that (1) the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section; (2) cash will be distributed first to WN until such time as he has received the amount of his original capital contribution ($990,000), next to KG until such time as he has received the amount of his original capital contribution ($10,000), and thereafter equally between WN and KG; (3) partnership net taxable income will be allocated 99 percent to WN and 1 percent to KG until the cumulative net taxable income allocated for all taxable years is equal to the cumulative net taxable loss previously allocated to the partners, and thereafter equally between WN and KG; (4) partnership net taxable loss will be allocated 99 percent to WN and 1 percent to KG, unless net taxable income has previously been allocated equally between WN and KG, in which case such net taxable loss first will be allocated equally until the cumulative net taxable loss allocated for all taxable years is equal to the cumulative net taxable income previously allocated to the partners; and (5) upon liquidation, WN is not required to restore any deficit balance in his capital account, but KG is so required. Since distributions in liquidation are not required to be made in accordance with the partners' positive capital account balances, and since WN is not required, upon the liquidation of his interest, to restore the deficit balance in his capital account to the partnership, the allocations provided by the partnership agreement do not have economic effect and will be reallocated in accordance with the partners' interests in the partnership under paragraph (b) (3) of this section.

(ii) Assume the same facts as in (i) except that the partnership agreement further provides that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(*d*) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(iii)(*d*) (*4*), (*5*), and (*6*) of this section are not reasonably expected to cause or increase a deficit balance in WN's capital account. The allocations provided by the partnership agreement have economic effect.

Example 17. FG and RP form a partnership with FG contributing cash of $100 and RP contributing property, with 2 years of cost recovery deductions remaining, that has an adjusted tax basis of $80 and a fair market value of $100. The partnership, FG, and RP have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, liquidation proceeds will be made in accordance with capital account balances, and each partner is liable to restore the deficit balance in his capital account to the partnership upon liquidation of his interest (as set forth in paragraphs (b)(2)(ii)(*b*) (*2*) and (*3*) of this section). FG expects to be in a substantially higher tax bracket than RP in the partnership's first taxable year. In the partnership's second taxable year, and in subsequent taxable years, it is expected that both will be in approximately equivalent tax brackets. The partnership agreement allocates all items equally except that all $50 of book depreciation is allocated to FG in the partnership's first taxable year and all $50 of book depreciation is allocated to RP in the partnership's second taxable year. If the allocation to FG of all book depreciation in the partnership's first taxable year is respected, FG would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. Likewise, if the allocation to RP of all the book depreciation in the partnership's second taxable year is respected, RP would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. The allocation of book depreciation to FG and RP in the partnership's first 2 taxable years has economic effect within the meaning of paragraph (b)(2)(ii) of this section. However, the economic effect of these allocations is not substantial under the test described in paragraph (b)(2)(iii)(*c*) of this section since there is a strong likelihood at the time such allocations became part of the partnership agreement that at the end of the 2-year period to which such allocations relate, the net increases and decreases to FG's and RP's capital accounts will be the same with such allocations as they would have been in the absence of such allocation, and the total tax liability of FG and RP for the taxable years to which the section 704(c) determinations relate would be reduced as a result of the allocations of book depreciation. As a result the allocations of book depreciation in the partnership agreement will be disregarded. FG and RP will be allocated such book depreciation in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts the book depreciation deductions will be reallocated equally between the partners, and section 704(c) will be applied with reference to such reallocation of book depreciation.

Example 18. (i) WM and JL form a general partnership by each contributing $300,000 thereto. The partnership uses the $600,000 to purchase an item of tangible personal property, which it leases out. The partnership elects under section 48 (q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that (1) the partners' capital account will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, (2) distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(*b*)(*2*) of this section), (3) any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(*b*)(*3*) of this section), (4) all income, gain, loss, and deduction of the partnership will be allocated equally between the partners, and (5) all nonliquidating distributions of the partnership will be made equally between the partners. Assume that in each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding cost recovery and depreciation deductions and gain or loss on the sale of its property). During its first 2 taxable years, the partnership has an additional $200,000 cost recovery deduction in each year. Pursuant to the partnership agreement these items are allocated equally between WM and JL.

	WM	*JL*
Capital account upon formation	$300,000	$300,000
Less: Net loss for years 1 and 2 ...	*(200,000)*	*(200,000)*
Capital account at end of year 2	$100,000	$100,000

The allocations made in the partnership's first 2 taxable years have substantial economic effect.

(ii) Assume the same facts as in (i) and that MK is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of his admission, the fair market value of the partnership property is $600,000. MK contributes $300,000 to the partnership in exchange for an equal one-third interest in the partnership, and, as permitted under paragraph (b)(2)(iv)(*g*), the capital accounts of WM and JL are adjusted upward to $300,000 each to reflect the fair market value of partnership property. In addition, the partnership agreement is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the partnership property that appreciated prior to MK's admission will be shared among the partners in a manner that takes account of the variation between such property's $200,000 adjusted tax basis and its $600,000 book value in accordance with paragraph (b)(2)(iv)(*f*) and the special rule contained in paragraph (b)(4)(i) of this section. Depreciation and gain or loss, as computed for book purposes, with respect to such property will be allocated equally among the partners and, in accordance with paragraph (b)(2)(iv)(*g*) of this section, will be reflected in the partner's capital accounts, as will all other partnership income, gain, loss, and deduction. Since the requirements of (b)(2)(iv)(*g*) of this section are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with paragraph (B)(2)(iv) of this section.

(iii) Assume the same facts as in (ii) and that immediately after MK's admission to the partnership, the partnership property is sold for $600,000, resulting in a taxable gain of $400,000 ($600,000 less $200,000 adjusted tax basis) and no book gain or loss, and the partnership is liquidated. An allocation of the $400,000 taxable gain cannot have economic effect because such gain cannot properly be reflected in the partners' book capital accounts. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $400,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between WM and JL.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	200,000	0	200,000	0	0	0
Capital account before liquidation	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000

The $900,000 of partnership cash ($600,000 sales proceeds plus $300,000 contributed by MK) is distributed equally among WM, JL, and MK in accordance with their adjusted positive capital account balances, each of which is $300,000.

(iv) Assume the same facts as in (iii) except that prior to liquidation the property appreciates and is sold for $900,000, resulting in a taxable gain of $700,000 ($900,000 less $200,000 adjusted tax basis) and a book gain of $300,000 ($900,000 less $600,000 book value). Under the partnership agreement the $300,000 of book gain is allocated equally among the partners, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	300,000	100,000	300,000	100,000	100,000	100,000
Capital account before liquidation	$400,000	$400,000	$400,000	$400,000	$400,000	$400,000

Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $700,000 taxable gain is, in accordance with section 704(c) principles, shared $300,000 to JL, $300,000 to WM, and $100,000 to MK. This ensures that (1) WM and JL share equally the $400,000 taxable gain that is attributable to appreciation in the property that occurred prior to MK's admission to the partnership in the same manner as it was reflected in their capital accounts upon MK's admission, and (2) WM, JL, and MK share equally the additional $300,000 taxable gain in the same manner as they shared the $300,000 book gain.

(v) Assume the same facts as in (ii) except that shortly after MK's admission the property depreciates and is sold for $450,000, resulting in a taxable gain of $250,000 ($450,000 less $200,000 adjusted tax basis) and a book loss of $150,000 (450,000 less $600,000 book value). Under the partnership agreement these items are allocated as follow:

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	125,000	0	125,000	0	0	0
Less: loss	0	(50,000)	0	(50,000)	0	(50,000)
Capital account before liquidation	$225,000	$250,000	$225,000	$250,000	$300,000	$250,000

The $150,000 book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $250,000 taxable gain is, in accordance with section 704(c) principles, shared equally between WM and JL. The fact that MK bears an economic loss of $50,000 without a corresponding taxable loss is attributable entirely to the ''ceiling rule.'' See paragraph (c)(2) of §1.704–1.

(vi) Assume the same facts as in (ii) except that the property depreciates and is sold for $170,000, resulting in a $30,000 taxable loss ($200,000 adjusted tax basis less $170,000) and a book loss of $430,000 ($600,000 book value less $170,000). The book loss of $430,000 is allocated equally among the partners ($143,333 each) and has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the entire $30,000 taxable loss is, in accordance with section 704(c) principles, included in MK's distributive share.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less Loss	0	(143,333)	0	(143,333)	(30,000)	(143,333)
Capital account before liquidation	$100,000	$156,667	$100,000	$156,667	$270,000	$156,667

(vii) Assume the same facts as in (ii) and that during the partnership's third taxable year, the partnership has an additional $100,000 cost recovery deduction and $300,000 book depreciation deduction attributable to the property purchased by the partnership in its first taxable year. The $300,000 book depreciation deduction is allocated equally among the partners, and that allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction for the partnership's third taxable year is, in accordance with section 704(c) principles, included in MK's distributive share. This is because under these facts those principles require MK to include the cost recovery deduction for such property in his distributive share up to the amount of the book depreciation deduction for such property properly allocated to him.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less: recovery/depreciation deduction for year 3	0	(100,000)	0	(100,000)	(100,000)	(100,000)
Capital account at end of year 3	$100,000	$200,000	$100,000	$200,000	$200,000	$200,000

(viii) Assume the same facts as in (vii) except that upon MK's admission the partnership property has an adjusted tax basis of $220,000 (instead of $200,000), and thus the cost recovery deduction for the partnership's third taxable year is $110,000. Assume further that upon MK's admission WM and JL have adjusted capital account balances of $110,000 and $100,000, respectively. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the excess $10,000 cost recovery deduction ($110,000 less $100,000 included in MK's distributive share) is, in accordance with section 704 (c) principles, shared equally between WM and JL and is so included in their respective distributive shares for the partnership's third taxable year.

(ix) Assume the same facts as in (vii) except that upon MK's admission the partnership agreement is amended to allocate the first $400,000 of book depreciation and loss on partnership property equally between WM and JL and the last $200,000 of such book depreciation and loss to MK. Assume such allocations have substantial economic effect. Pursuant to this amendment the $300,000 book depreciation deduction in the partnership's third taxable year is allocated equally between WM and JL. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction is, in accordance with section 704(c) principles, shared equally between WM and JL. In the partnership's fourth taxable year, it has a $60,000 cost recovery deduction and a $180,000 book depreciation deduction. Under the amendment described above, the $180,000 book depreciation deduction is allocated $50,000 to WM, $50,000 to JL, and $80,000 to MK. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction is, in accordance with section 704(c) principles, included entirely in MK's distributive share.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less:						
(a) recovery/depreciation deduction for year 3	(50,000)	(150,000)	(50,000)	(150,000)	0	0
(b) recovery/depreciation deduction for year 4	0	(50,000)	0	(50,000)	(60,000)	(80,000)
Capital account at end of year 4	$50,000	$100,000	$50,000	$100,000	$240,000	$220,000

(x) Assume the same facts as in (vii) and that at the beginning of the partnership's third taxable year, the partnership purchases a second item of tangible personal property for $300,000 and elects under section 48(q) (4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement is amended to allocate the first $150,000 of cost recovery deductions and loss from such property to WM and the next $150,000 of cost recovery deductions and loss from such property equally between JL and MK. Thus, in the partnership's third taxable year it has, in addition to the items specified in (vii), a cost recovery and book depreciation deduction of $100,000 attributable to the newly acquired property, which is allocated entirely to WM.

As in (vii), the allocation of the $300,000 book depreciation attributable to the property purchased in the partnership's first taxable year equally among the partners has substantial economic effect, and consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement properly provides for the entire $100,000 cost recovery deduction attributable to such property to be included in MK's distributive share. Furthermore, the allocation to WM of the $100,000 cost recovery deduction attributable to the property purchased in the partnership's third taxable year has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less:						
(a) recovery/depreciation deduction for property bought in year 1	0	(100,000)	0	(100,000)	(100,000)	(100,000)
(b) recovery/depreciation deduction for property bought in year 3	(100,000)	(100,000)	0	0	0	0
Capital account at end of year 3 ...	0	$100,000	$100,000	$200,000	$200,000	$200,000

(xi) Assume the same facts as in (x) and that at the beginning of the partnership's fourth taxable year, the properties purchased in the partnership's first and third taxable years are disposed of for $90,000 and $180,000, respectively, and the partnership is liquidated. With respect to the property purchased in the first taxable year, there is a book loss of $210,000 ($300,000 book value less $90,000) and a taxable loss of $10,000 ($100,000 adjusted tax basis less $90,000). The book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the taxable loss of $10,000 will, in accordance with section 704(c) principles, be included entirely in MK's distributive share. With respect to the property purchased in the partnership's third taxable year, there is a book and taxable loss of $20,000. Pursuant to the partnership agreement this loss is allocated entirely to WM, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 4	0	$100,000	$100,000	$200,000	$200,000	$200,000
Less:						
(a) loss on property bought in year 1	0	(70,000)	0	(70,000)	(10,000)	(70,000)
(b) loss on property bought in year 3	(20,000)	(20,000)	0	0	0	0
Capital account before liquidation	($20,000)	$10,000	$100,000	$130,000	$190,000	$130,000

Partnership liquidation proceeds ($270,000) are properly distributed in accordance with the partners' adjusted positive book capital account balances ($10,000 to WM, $130,000 to JL and $130,000 to MK).

(xii) Assume the same facts as in (x) and that in the partnership's fourth taxable year it has a cost recovery deduction of $60,000 and book depreciation deduction of $180,000 attributable to the property purchased in the partnership's first taxable year, and a cost recovery and book depreciation deduction of $100,000 attributable to the property purchased in the partnership's third taxable year. The $180,000 book depreciation deduction attributable to the property purchased in the partnership's first taxable year is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction attributable to the property purchased in the first taxable year is, in accordance with section 704(c) principles, included entirely in MK's distributive share. Furthermore, the $100,000 cost recovery deduction attributable to the property purchased in the third taxable year is allocated $50,000 to WM, $25,000 to JL, and $25,000 to MK, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 4	0	$100,000	$100,000	$200,000	$200,000	$200,000
Less:						
(a) recovery/depreciation deduction for property bought in year 1	0	(60,000)	0	(60,000)	(60,000)	(60,000)
(b) recovery/depreciation deduction for property bought in year 3	(50,000)	(50,000)	(25,000)	(25,000)	(25,000)	(25,000)
Capital account at end of year 4	($50,000)	($10,000)	$75,000	$115,000	$115,000	$115,000

At the end of the partnership's fourth taxable year the adjusted tax bases of the partnership properties acquired in its first and third taxable years are $40,000 and $100,000, respectively. If the properties are disposed of at the beginning of the partnership's fifth taxable year for their adjusted tax bases, there would be no taxable gain or loss, a book loss of $80,000 on the property purchased in the partnership's first taxable year ($120,000 book value less $40,000), and cash available for distribution of $140,000.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 5	($50,000)	($10,000)	$75,000	$115,000	$115,000	$115,000
Less: loss	0	(26,667)	0	(26,667)	0	(26,667)
Capital account before liquidation	($50,000)	($36,667)	$75,000	$88,333	$115,000	$88,333

If the partnership is then liquidated, the $140,000 of cash on hand plus the $36,667 balance that WM would be required to contribute to the partnership (the deficit balance in his book capital account) would be distributed equally between JL and MK in accordance with their adjusted positive book capital account balances.

(xiii) Assume the same facts as in (i). Any tax preferences under section 57(a)(12) attributable to the partnership's cost recovery deductions in the first 2 taxable years will be taken into account equally by WM and JL. If the partnership agreement instead provides that the partnership's cost recovery deductions in its first 2 taxable years are allocated 25 percent to WM and 75 percent to JL (and such allocations have substantial economic effect), the tax preferences attributable to such cost recovery deductions would be taken into account 25 percent by WM and 75 percent by JL. The conclusion in the previous sentence is unchanged even if the partnership's operating expenses (exclusive of cost recovery and depreciation deductions) exceed its operating income in each of the partnership's first 2 taxable years, the resulting net loss is allocated entirely to WM, and the cost recovery deductions are allocated 25 percent to WM and 75 percent to JL (provided such allocations have substantial economic effect). If the partnership agreement instead provides that all income, gain, loss, and deduction (including cost recovery and depreciations) are allocated equally between JL and WM, the tax preferences attributable to the cost recovery deductions would be taken into account equally by JL and WM. In this case, if the partnership has a $100,000 cost recovery deduction in its first taxable year and an additional net loss of $100,000 in its first taxable year (*i.e.*, its operating expenses exceed its operating income by $100,000) and purports to categorize JL's $100,000 distributive share of partnership loss as being attributable to the cost recovery deduction and WM's $100,000 distributive share of partnership loss as being attributable to the net loss, the economic effect of such allocations is not substantial, and each partner will be allocated one-half of all partnership income, gain, loss, and deduction and will take into account one-half of the tax preferences attributable to the cost recovery deductions.

Example 19. (i) DG and JC form a general partnership for the purpose of drilling oil wells. DG contributes an oil lease, which has a fair market value and adjusted tax basis of $100,000. JC contributes $100,000 in cash, which is used to finance the drilling operations. The partnership agreement provides that DG is credited with a capital account of $100,000, and JC is credited with a capital account of $100,000. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b) (*2*) and (*3*) of this section. The partnership chooses to adjust capital accounts on a simulated cost depletion basis and elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the basis of its section 38 property. The agreement further provides that (1) all additional cash requirements of the partnership will be borne equally by DG and JC, (2) the deductions attributable to the property (including money) contributed by each partner will be allocated to such partner, (3) all other income, gain, loss, and deductions (and item thereof) will be allocated equally between DG and JC, and (4) all cash from operations will be distributed equally between DG and JC. In the partnership's first taxable year $80,000 of partnership intangible drilling cost deductions and $20,000 of cost recovery deductions on partnership equipment are allocated to JC, and the $100,000 basis of the lease is, for purposes of the depletion allowance under sections 611 and 613A(c)(7)(D), allocated to DG. The allocations of income, gain, loss, and deduction provided in the partnership agreement have substantial economic effect. Furthermore, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(*iv*)(*k*) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the $100,000 adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital for purposes of section 613A(c)(7)(D).

(ii) Assume the same facts as in (i) except that the partnership agreement provides that (1) all additional cash requirements of the partnership for additional expenses will be funded by additional contributions from JC, (2) all cash from operations will first be distributed to JC until the excess of such cash distributions over the amount of such additional expense equals his initial $100,000 contributions, (3) all deductions attributable to such additional operating expenses will be allocated to JC, and (4) all income will be allocated to JC until the aggregate amount of income allocated to him equals the amount of partnership operating expenses funded by his initial $100,000 contribution plus the amount of additional operating expenses paid from contributions made solely by him. The allocations of income, gain, loss, and deduction provided in partnership agreement have economic effect. In addition, the economic effect of the allocations provided in the agreement is substantial. Because the partnership's drilling activities are sufficiently speculative, there is not a strong likelihood at the time the disproportionate allocations of loss and deduction to JC are provided for by the partnership agreement that the economic effect of such allocations will be largely offset by allocations of income. In addition, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(*iv*)(*k*) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D).

(iii) Assume the same facts as in (i) except that all distributions, including those made upon liquidation of the partnership, will be made equally between DG and JC, and no partner is obligated to restore the deficit balance in his capital account to the partnership following the liquidation of his interest for distribution to partners with positive capital account balances. Since liquidation proceeds will be distributed equally between DG and JC irrespective of their capital account balances, and since no partner is required to restore the deficit balance in his capital account to the partnership upon liquidation (in accordance with paragraph (b)(2)(ii)(b)(3) of this section), the allocations of income, gain, loss, and deduction provided in the partnership agreement do not have economic effect and must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts all partnership income, gain, loss, and deduction (and item thereof) will be reallocated equally between JC and DG. Furthermore, the allocation of the $100,000 adjusted tax basis of the lease of DG is not, under paragraph (b)(4)(v) of this section, deemed to be in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), and such basis must be reallocated in accordance with the partners' interests in partnership capital or income as determined under section 613A(c)(7)(D). The results in this example would be the same if JC's initial cash contribution were $1,000,000 (instead of $100,000), but in such case the partners should consider whether, and to what extent, the provisions of paragraph (b)(1) of § 1.721–1, and principles related thereto, may be applicable.

(iv) Assume the same facts as in (i) and that for the partnership's first taxable year the simulated depletion deduction with respect to the lease is $10,000. Since DG properly was allocated the entire depletable basis of the lease (such allocation having been recognized as being in accordance with DG's interest in partnership capital with respect to such lease), under paragraph (b)(2)(iv)(*k*)(*1*) of this section the partnership's $10,000 simulated depletion deduction is allocated to DG and will reduce his capital account accordingly. If (prior to any additional simulated depletion deductions) the lease is sold for $100,000, paragraph (b)(4)(v) of this section requires that the first $90,000 (*i.e.*, the partnership's simulated adjusted basis in the lease) out of the $100,000 amount realized on such sale be allocated to DG (but does not directly affect his capital account). The partnership agreement allocates the remaining $10,000 amount realized equally between JC and DG (but such allocation does not directly affect their capital accounts). This allocation of the $10,000 portion of amount realized that exceeds the partnership's simulated adjusted basis in the lease will be treated as being in accordance with the partners' allocable shares of such amount realized under section 613A(c)(7)(D) because such allocation will not result in capital account adjustments (under paragraph (b)(2)(iv)(*k*) of this section) the economic effect of which is insubstantial, and all other partnership allocations are recognized under this paragraph. Under paragraph (b)(2)(iv)(*k*) of this section, the partners' capital accounts are adjusted upward by the partnership's simulated gain of $10,000 ($100,000 sales price less $90,000 simulated adjusted basis) in proportion to such partners' allocable shares of the $10,000 portion of the total amount realized that exceeds the partnership's $90,000 simulated adjusted basis ($5,000 to JC and $5,000 to DG). If the lease is sold for $50,000, under paragraph (b)(4)(v) of this section the entire $50,000 amount realized on the sale of the lease will be allocated to DG (but will not directly affect his capital account). Under paragraph (b)(2)(iv)(*k*) of this section the partners' capital accounts will be adjusted downward by the partnership's $40,000 simulated loss ($50,000 sales price less $90,000 simulated adjusted basis) in proportion to the partners' allocable shares of the total amount realized from the property that represents recovery of the partnership's simulated adjusted basis therein. Accordingly, DG's capital account will be reduced by such $40,000.

(c) *Contributed property; cross-reference.* See § 1.704–3 for methods of making allocations that take into account precontribution appreciation or diminution in value of property contributed by a partner to a partnership.

(d) *Limitation on allowance of losses.* (1) A partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a) (1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and § 1.752–1.

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

Example 1. At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end of such year, A's adjusted basis for his interest in the partnership (not taking into account his distributive share of the loss) is $6,000. Under section 704(d), A's distributive share of partnership loss is allowed to him (in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example 2. At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and §§ 1.752–1 and 1.722–1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704(d), for his taxable year within or with which partnership taxable year 1956 ends.

Example 3. At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702(a): Long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702(a)(9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705(a)(1)(A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

(e) *Family partnerships*—(1) *In general*—(i) *Introduction.* The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K, chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

(ii) *Recognition of donee as partner.* With respect to partnerships in which capital is a material income-producing factor, section 704(e)(1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership whether or not such interest is derived by purchase or gift from any other person. If a capital interest in a partnership in which capital is a material income-producing factor is created by gift, section 704(e)(2) provides that the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such distributive share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. For rules of allocation in such cases, see subparagraph (3) of this paragraph.

(iii) *Requirement of complete transfer to donee.* A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides or lack of bona fides of the purported gift or sale. A partnership may be recognized for income tax purposes as to some partners but not as to others.

(iv) *Capital as a material income-producing factor.* For purposes of section 704(e)(1), the determination as to whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(v) *Capital interest in a partnership.* For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

(2) *Basic tests as to ownership*—(i) *In general.* Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case. Isolated facts are not determinative; the reality of the donee's ownership is to be determined in the light of the transaction as a whole. The execution of legally sufficient and irrevocable deeds or other instruments of gift under State law is a factor to be taken into account but is not determinative of ownership by the donee for the purposes of section 704(e). The reality of the transfer and of the donee's ownership of the property attributed to him are to be ascertained from the conduct of the parties with respect to the

alleged gift and not by any mechanical or formal test. Some of the more important factors to be considered in determining whether the donee has acquired ownership of the capital interest in a partnership are indicated in subdivisions (ii) to (x), inclusive, of this subparagraph.

(ii) *Retained controls.* The donor may have retained such controls of the interest which he has purported to transfer to the donee that the donor should be treated as remaining the substantial owner of the interest. Controls of particular significance include, for example, the following:

(a) Retention of control of the distribution of amounts of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business). If there is a partnership agreement providing for a managing partner or partners, then amounts of income may be retained in the partnership without the acquiescence of all the partners if such amounts are retained for the reasonable needs of the business.

(b) Limitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment.

(c) Retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership).

(d) Retention of management powers inconsistent with normal relationships among partners. Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners, provided the donee is free to liquidate his interest at his discretion without financial detriment. The donee shall not be considered free to liquidate his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and capable of exercising, his right to withdraw his capital interest from the partnership.

The existence of some of the indicated controls, though amounting to less than substantial ownership retained by the donor, may be considered along with other facts and circumstances as tending to show the lack of reality of the partnership interest of the donee.

(iii) *Indirect controls.* Controls inconsistent with ownership by the donee may be exercised indirectly as well as directly, for example, through a separate business organization, estate, trust, individual, or other partnership. Where such indirect controls exist, the reality of the donee's interest will be determined as if such controls were exercisable directly.

(iv) *Participation in management.* Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest. Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

(v) *Income distributions.* The actual distribution to a donee partner of the entire amount or a major portion of his distributive share of the business income for the sole benefit and use of the donee is substantial evidence of the reality of the donee's interest, provided the donor has not retained controls inconsistent with real ownership by the donee. Amounts distributed are not considered to be used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in such manner that the donor controls or can control the use or enjoyment of such funds.

(vi) *Conduct of partnership business.* In determining the reality of the donee's ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. Whether or not the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance. Other factors of significance in this connection include:

(a) Compliance with local partnership, fictitious names, and business registration statutes.

(b) Control of business bank accounts.

(c) Recognition of the donee's rights in distributions of partnership property and profits.

(d) Recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting business.

(e) The existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(f) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

(vii) *Trustees as partners.* A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular consideration:

(a) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

(b) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries.

(viii) *Interests (not held in trust) of minor children.* Except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit. ''Judicial supervision of the conduct of the fiduciary'' includes filing of such accountings and reports as are required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. A minor child will be considered as competent to manage his own property if he actually has sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and otherwise to conduct his affairs on a basis of equality with adult persons, notwithstanding legal disabilities of the minor under State law.

(ix) *Donees as limited partners.* The recognition of a donee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and on whether the donee has acquired dominion and control over the interest purportedly transferred to him. To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

(x) *Motive.* If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.

(3) *Allocation of family partnership income*—(i) *In general.* (*a*) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(b) To the extent that the partnership agreement does not allocate the partnership income in accordance with *(a)* of this subdivision, the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(c) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(d) The distributive share of partnership income, as determined under (*b*) of this subdivision, of a partner who rendered services to the partnership before entering the Armed Forces of the United States shall not be diminished because of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

(ii) *Special rules. (a)* The provisions of subdivision (i) of this subparagraph, relating to allocation of family partnership income, are applicable where the interest in the partnership is created by gift, indirectly or directly. Where the partnership interest is created indirectly, the term *donor* may include persons other than the nominal transferor. This rule may be illustrated by the following examples:

Example 1. A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Example 2. A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently conveys her interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

Example 3. A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, for purposes of section 704, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(b) The allocation rules set forth in section 704(e) and subdivision (i) of this subparagraph apply in any case in which the transfer or creation of the partnership interest has any of the substantial characteristics of a gift. Thus, allocation may be required where transfer of a partnership interest is made between members of a family (including collaterals) under a purported purchase agreement, if the characteristics of a gift are ascertained from the terms of the purchase agreement, the terms of any loan or credit arrangements made to finance the purchase, or from other relevant data.

(c) In the case of a limited partnership, for the purpose of the allocation provisions of subdivision (i) of this subparagraph, consideration shall be given to the fact that a general partner, unlike a limited partner, risks his credit in the partnership business.

(4) *Purchased interest*—(i) *In general.* If a purported purchase of a capital interest in a partnership does not meet the requirements of subdivision (ii) of this subparagraph, the ownership by the transferee of such capital interest will be recognized only if it qualifies under the requirements applicable to a transfer of a partnership interest by gifts. In a case not qualifying under subdivision (ii) of this subparagraph, if payment of any part of the purchase price is made out of partnership earnings, the transaction may be regarded in the same light as a purported gift subject to deferred enjoyment of income. Such a transaction may be lacking in reality either as a gift or as a bona fide purchase.

(ii) *Tests as to reality of purchased interests.* A purchase of a capital interest in a partnership, either directly or by means of a loan or credit extended by a member of the family, will be recognized as bona fide if:

(a) It can be shown that the purchase has the usual characteristics of an arm's-length transaction, considering all relevant factors, including the terms of the purchase agreement (as to price, due date of payment, rate of interest, and security, if any) and the terms of any loan or credit arrangement collateral to the purchase agreement; the credit standing of the purchaser (apart from relationship to the seller) and the capacity of the purchaser to incur a legally binding obligation; or

(b) It can be shown, in the absence of characteristics of an arm's-length transaction, that the purchase was genuinely intended to promote the success of the business by securing participation of the purchaser in the business or by adding his credit to that of the other participants.

However, if the alleged purchase price or loan has not been paid or the obligation otherwise discharged, the factors indicated in (*a*) and (*b*) of this subdivision shall be taken into account only as an aid in determining whether a bona fide purchase or loan obligation existed.

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§ 1.704–2 Allocations attributable to nonrecourse liabilities.

(a) *Table of contents.* This paragraph contains a listing of the major headings of this § 1.704–2.

§ 1.704–2 Allocations attributable to nonrecourse liabilities.

(b) *General principles and definitions*—(1) *Definition of and allocations of nonrecourse deductions.* Allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities (''nonrecourse deductions'') cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners' interests in the partnership. If that test is not satisfied, the partners' distributive shares of nonrecourse deductions are determined under § 1.704–1(b)(3), according to the partners' overall economic interests in the partnership. See also paragraph (i) of this section for special rules regarding the allocation of deductions attributable to nonrecourse liabilities for which a partner bears the economic risk of loss (as described in paragraph (b)(4) of this section).

(2) *Definition of and allocations pursuant to a minimum gain chargeback.* To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (''partnership minimum gain''). An increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability and by a partnership nonrecourse borrowing that exceeds the adjusted tax basis of the property encumbered by the borrowing. Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. Allocations of gain attributable to a decrease in partnership minimum gain (a ''minimum gain chargeback,'' as required under paragraph (f) of this section) cannot have economic effect because the gain merely offsets nonrecourse deductions previously claimed by the partnership. Thus, to avoid impairing the economic effect of other allocations, allocations pursuant to a minimum gain chargeback must be made to the partners that either were allocated nonrecourse deductions or received distributions of proceeds attributable to a nonrecourse borrowing. Paragraph (e) of this section provides a test that, if met, deems allocations of partnership income pursuant to a minimum gain chargeback to be in accordance with the partners' interests in the partnership. If property encumbered by a nonrecourse liability is reflected on the partnership's books at a value that differs from its adjusted tax basis, paragraph (d)(3) of this section provides that minimum gain is determined with reference to the property's book basis. See also paragraph (i)(4) of this section for special rules regarding the minimum gain chargeback requirement for partner nonrecourse debt.

(3) *Definition of nonrecourse liability. Nonrecourse liability* means a nonrecourse liability as defined in § 1.752–1(a)(2).

(4) *Definition of partner nonrecourse debt. Partner nonrecourse debt* or *partner nonrecourse liability* means any partnership liability to the extent the liability is nonrecourse for purposes of § 1.1001–2, and a partner or related person (within the meaning of § 1.752–4(b)) bears the economic risk of loss under § 1.752–2 because, for example, the partner or related person is the creditor or a guarantor.

(c) *Amount of nonrecourse deductions.* The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (h) of this section). See paragraph (m), *Examples* (1)(i) and (vi), (2), and (3) of this section. However, increases in partnership minimum gain resulting from conversions, refinancings, or other changes to a debt instrument (as described in paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse deductions consist first of certain depreciation or cost recovery deductions and then, if necessary, a pro rata portion of other partnership losses, deductions, and section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over. See paragraphs (j)(1) (ii) and (iii) of this section for more specific ordering rules. See also paragraph (m), *Example* (1)(iv) of this section.

(d) *Partnership minimum gain*—(1) *Amount of partnership minimum gain.* The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year. See paragraph (m), *Examples* (1) (i) and (iv), (2), and (3) of this section.

(2) *Property subject to more than one liability.* (i) *In general.* If property is subject to more than one liability, only the portion of the property's adjusted tax basis that is allocated to a nonrecourse liability under paragraph (d)(2)(ii) of this section is used to compute minimum gain with respect to that liability.

(ii) *Allocating liabilities.* If property is subject to two or more liabilities of equal priority, the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. See paragraph (m), *Example* (1) (v) and (vii) of this section.

(3) *Partnership minimum gain if there is a book/tax disparity.* If partnership property subject to one or more nonrecourse liabilities is, under §1.704–1(b)(2)(iv) (*d*), (*f*), or (*r*), reflected on the partnership's books at a value that differs from its adjusted tax basis, the determinations under this section are made with reference to the property's book value. See section 704(c) and §1.704–1(b)(4)(i) for principles that govern the treatment of a partner's share of minimum gain that is eliminated by the revaluation. See also paragraph (m), *Example* (3) of this section.

(4) *Special rule for year of revaluation.* If the partners' capital accounts are increased pursuant to §1.704–1(b)(2)(iv) (*d*), (*f*), or (*r*) to reflect a revaluation of partnership property subject to a nonrecourse liability, the net increase or decrease in partnership minimum gain for the partnership taxable year of the revaluation is determined by:

(i) First calculating the net decrease or increase in partnership minimum gain using the current year's book values and the prior year's partnership minimum gain amount; and

(ii) Then adding back any decrease in minimum gain arising solely from the revaluation.

See paragraph (m), *Example* (3)(iii) of this section. If the partners' capital accounts are decreased to reflect a revaluation, the net increases or decreases in partnership minimum gain are determined in the same manner as in the year before the revaluation, but by using book values rather than adjusted tax bases. See section 7701(g) and §1.704–1(b)(2)(iv)(*f*)(*1*) (property being revalued cannot be booked down below the amount of any nonrecourse liability to which the property is subject).

(e) *Requirements to be satisfied.* Allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if—

(1) Throughout the full term of the partnership requirements (*1*) and (*2*) of §1.704–1(b)(2)(ii)(*b*) are satisfied (*i.e.*, capital accounts are maintained in accordance with §1.704–1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (*3*) of either §1.704–1(b)(2)(ii)(*b*) or §1.704–1(b)(2)(ii)(*d*) is satisfied (*i.e.*, partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);

(2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;

(3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under § 1.704–1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under § 1.704–1(b)(4)(v)).

(f) *Minimum gain chargeback requirement*—(1) *In general.* If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2)).

(2) *Exception for certain conversions and refinancings.* A partner is not subject to the minimum gain chargeback requirement to the extent the partner's share of the net decrease in partnership minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing it to become partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of § 1.752–2) for the newly guaranteed, refinanced, or otherwise changed liability.

(3) *Exception for certain capital contributions.* A partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and the partner's share of the net decrease in partnership minimum gain results from the repayment or the increase to the property's basis. See paragraph (m), *Example* (1)(iv) of this section.

(4) *Waiver for certain income allocations that fail to meet minimum gain chargeback requirement if minimum gain chargeback distorts economic arrangement.* In any taxable year that a partnership has a net decrease in partnership minimum gain, if the minimum gain chargeback requirement would cause a distortion in the economic arrangement among the partners and it is not expected that the partnership will have sufficient other income to correct that distortion, the Commissioner has the discretion, if requested by the partnership, to waive the minimum gain chargeback requirement. The following facts must be demonstrated in order for a request for a waiver to be considered:

(i) The partners have made capital contributions or received net income allocations that have restored the previous nonrecourse deductions and the distributions attributable to proceeds of a nonrecourse liability; and

(ii) The minimum gain chargeback requirement would distort the partners' economic arrangement as reflected in the partnership agreement and as evidenced over the term of the partnership by the partnership's allocations and distributions and the partners' contributions.

(5) *Additional exceptions.* The Commissioner may, by revenue ruling, provide additional exceptions to the minimum gain chargeback requirement.

(6) *Partnership items subject to the minimum gain chargeback requirement.* Any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then if necessary consists of a pro rata portion of the partnership's other items of income and gain for that year. If the amount of the minimum gain chargeback requirement exceeds the partnership's income and gains for the taxable year, the excess carries over. See paragraphs (j)(2) (i) and (iii) of this section for more specific ordering rules.

(7) *Examples.* The following examples illustrate the provisions in § 1.704–2(f).

Example. 1. Partnership AB consists of two partners, limited partner A and general partner B. Partner A contributes $90 and Partner

B contributes $10 to the partnership. The partnership agreement has a minimum gain chargeback provision and provides that, except as otherwise required by section 704(c), all losses will be allocated 90 percent to A and 10 percent to B; and that all income will be allocated first to restore previous losses and thereafter 50 percent to A and 50 percent to B. Distributions are made first to return initial capital to the partners and then 50 percent to A and 50 percent to B. Final distributions are made in accordance with capital account balances. The partnership borrows $200 on a nonrecourse basis from an unrelated third party and purchases an asset for $300. The partnership's only tax item for each of the first three years in $100 of depreciation on the asset. A's and B's shares of minimum gain (under paragraph (g) of this section) and deficit capital account balances are $180 and $20 respectively at the end of the third year. In the fourth year, the partnership earns $400 of net operating income and allocates the first $300 to restore the previous losses (*i.e.*, $270 to A and $30 to B); the last $100 is allocated $50 each. The partnership distributes $200 of the available cash that same year; the first $100 is distributed $90 to A and $10 to B to return their capital contributions; the last $100 is distributed $50 each to reflect their ratio for sharing profits.

	A	B
Capital account on formation	$90	$10
Less: Net loss in years 1–3	($270)	($30)
Capital account at end of year 3	($180)	($20)
Allocation of operating income to restore nonrecourse deductions	$180	$20
Allocation of operating income to restore capital contributions	$90	$10
Allocation of operating income to reflect profits	$50	$50
Capital accounts after allocation of operating income	$140	$60
Distribution reflecting capital contribution	($90)	($10)
Distribution in profit-sharing ratio	($50)	($50)
Capital accounts following distribution	($0)	($0)

In the fifth year, the partnership sells the property for $300 and realizes $300 of gain. $200 of the proceeds are used to pay the nonrecourse lender. The partnership has $300 to distribute, and the partners expect to share that equally. Absent a waiver under paragraph (f)(4) of this section, the minimum gain chargeback would require the partnership to allocate the first $200 of the gain $180 to A and $20 to B, which would distort their economic arrangement. This allocation, together with the allocation of the $100 profit $50 to each partner, would result in A having a positive capital account balance of $230 and B having a positive capital account balance of $70. The allocation of income in year 4 in effect anticipated the minimum gain chargeback that did not occur until year 5. Assuming the partnership would not have sufficient other income to correct the distortion that would otherwise result, the partnership may request that the Commissioner exercise his or her discretion to waive the minimum gain chargeback requirement and recognize allocations that would allow A and B to share equally the gain on the sale of the property. These allocations would bring the partners' capital accounts to $150 each, allowing them to share the last $300 equally. The Commissioner may, in his or her discretion, permit this allocation pursuant to paragraph (f)(4) of this section because the minimum gain chargeback would distort the partners' economic arrangement over the term of the partnership as reflected in the partnership agreement and as evidenced by the partners' contributions and the partnership's allocations and distributions.

Example 2. A and B form a partnership, contribute $25 each to the partnership's capital, and agree to share all losses and profits 50 percent each. Neither partner has an unconditional deficit restoration obligation and all the requirements in paragraph (e) of this section are met. The partnership obtains a nonrecourse loan from an unrelated third party of $100 and purchases two assets, stock for $50 and depreciable property for $100. The nonrecourse loan is secured by the partnership's depreciable property. The partnership generates $20 of depreciation in each of the first five years as its only tax item. These deductions are properly treated as nonrecourse deductions and the allocation of these deductions 50 percent to A and 50 percent to B is deemed to be in accordance with the partners' interests in the partnership. At the end of year five, A and B each have a $25 deficit capital account and a $50 share of partnership minimum gain. In the beginning of year six, (at the lender's request), A guarantees the entire nonrecourse liability. Pursuant to paragraph (d)(1) of this section, the partnership has a net decrease in minimum gain of $100 and under paragraph (g)(2) of this section, A's and B's shares of that net decrease are $50 each. Under paragraph (f)(1) of this section (the minimum gain chargeback requirement), B is subject to a $50 minimum gain chargeback. Because the partnership has no gross income in year six, the entire $50 carries over as a minimum gain chargeback requirement to succeeding taxable years until their is enough income to cover the minimum gain chargeback requirement. Under the exception to the minimum gain chargeback in paragraph (f)(2) of this section, A is not subject to a minimum gain chargeback for A's $50 share of the net decrease because A bears the economic risk of loss for the liability. Instead, A's share of partner nonrecourse debt minimum gain is

$50 pursuant to paragraph (i)(3) of this section. In year seven, the partnership earns $100 of net operating income and uses the money to repay the entire $100 nonrecourse debt (that A has guaranteed). Under paragraph (i)(3) of this section, the partnership has a net decrease in partner nonrecourse debt minimum gain of $50. B must be allocated $50 of the operating income pursuant to the carried over minimum gain chargeback requirement; pursuant to paragraph (i)(4) of this section, the other $50 of operating income must be allocated to A as a partner nonrecourse debt minimum gain chargeback.

(g) *Shares of partnership minimum gain*—(1) *Partner's share of partnership minimum gain.* Except as increased in paragraph (g) (3) of this section, a partner's share of partnership minimum gain at the end of any partnership taxable year equals:

(i) The sum of nonrecourse deductions allocated to that partner (and to that partner's predecessors in interest) up to that time and the distributions made to that partner (and to that partner's predecessors' in interest) up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain (see paragraph (h)(1) of this section); minus

(ii) The sum of that partner's (and that partner's predecessors' in interest) aggregate share of the net decreases in partnership minimum gain plus their aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership nonrecourse liabilities.

For purposes of §1.704–1(b)(2)(ii)(*d*), a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore. See paragraph (m), *Examples* (1)(i) and (3)(i) of this section.

(2) *Partner's share of the net decrease in partnership minimum gain.* A partner's share of the net decrease in partnership minimum gain is the amount of the total net decrease multiplied by the partner's percentage share of the partnership's minimum gain at the end of the immediately preceding taxable year. A partner's share of any decrease in partnership minimum gain resulting from a revaluation of partnership property equals the increase in the partner's capital account attributable to the revaluation to the extent the reduction in minimum gain is caused by the revaluation. See paragraph (m), *Example* (3)(ii) of this section.

(3) *Conversions of recourse or partner nonrecourse debt into nonrecourse debt.* A partner's share of partnership minimum gain is increased to the extent provided in this paragraph (g)(3) if a refinancing, the lapse of a guarantee, or other change to a debt instrument causes a recourse or partner nonrecourse liability to become partially or wholly nonrecourse. If a recourse liability becomes a nonrecourse liability, a partner has a share of the partnership's minimum gain that results from the conversion equal to the partner's deficit capital account (determined under §1.704–1(b)(2)(iv)) to the extent the partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. For purposes of the preceding sentence, the determination of the extent to which a partner bears the economic burden for a deficit capital account is made by determining the consequences to the partner in the case of a complete liquidation of the partnership immediately after the conversion applying the rules described in §1.704–1(b)(2)(iii)(*c*) that deem the value of partnership property to equal its basis, taking into account section 7701(g) in the case of property that secures nonrecourse indebtedness. If a partner nonrecourse debt becomes a nonrecourse liability, the partner's share of partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under paragraph (i)(4) of this section.

(h) *Distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain*—(1) *In general.* If during its taxable year a partnership makes a distribution to the partners allocable to the proceeds of a nonrecourse liability, the distribution is allocable to an increase in partnership minimum gain to the extent the increase results from encumbering partnership property with aggregate nonrecourse liabilities that exceed the property's adjusted tax basis. See paragraph (m), *Example* (1)(vi) of this section. If the net increase in partnership minimum gain for a partnership taxable year is allocable to more than one nonrecourse liability, the net increase is allocated among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain.

(2) *Distribution allocable to nonrecourse liability proceeds.* A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability. The rules prescribed under § 1.163–8T for allocating debt proceeds among expenditures (applying those rules to the partnership as if it were an individual) constitute a reasonable method for determining whether the nonrecourse liability proceeds are distributed to the partners and the partners to whom the proceeds are distributed.

(3) *Option when there is an obligation to restore.* A partnership may treat any distribution to a partner of the proceeds of a nonrecourse liability (that would otherwise be allocable to an increase in partnership minimum gain) as a distribution that is not allocable to an increase in partnership minimum gain to the extent the distribution does not cause or increase a deficit balance in the partner's capital account that exceeds the amount the partner is otherwise obligated to restore (within the meaning of § 1.704–1(b)(2)(ii)(*c*)) as of the end of the partnership taxable year in which the distribution occurs.

(4) *Carryover to immediately succeeding taxable year.* The carryover rule of this paragraph applies if the net increase in partnership minimum gain for a partnership taxable year that is allocable to a nonrecourse liability under paragraph (h)(2) of this section exceeds the distributions allocable to the proceeds of the liability (''excess allocable amount''), and all or part of the net increase in partnership minimum gain for the year is carried over as an increase in partnership minimum gain for the immediately succeeding taxable year (pursuant to paragraph (j)(1)(iii) of this section). If the carryover rule of this paragraph applies, the excess allocable amount (or the amount carried over under paragraph (j)(1)(iii) of this section, if less) is treated in the succeeding taxable year as an increase in partnership minimum gain that arose in that year as a result of incurring the nonrecourse liability to which the excess allocable amount is attributable. See paragraph (m), *Example* (1)(vi) of this section. If for a partnership taxable year there is an excess allocable amount with respect to more than one partnership nonrecourse liability, the excess allocable amount is allocated to each liability in proportion to the amount each liability contributed to the increase in minimum gain.

(i) *Partnership nonrecourse liabilities where a partner bears the economic risk of loss*—(1) *In general.* Partnership losses, deductions, or section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability (''partner nonrecourse deductions,'' as defined in paragraph (i)(2) of this section) must be allocated to the partner that bears the economic risk of loss for the liability. If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability.

(2) *Definition of and determination of partner nonrecourse deductions.* For any partnership taxable year, the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals the net increase during the year in minimum gain attributable to the partner nonrecourse debt (''partner nonrecourse debt minimum gain''), reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner nonrecourse debt minimum gain. See paragraph (m), *Example* (1) (viii) and (ix) of this section. The determination of which partnership items

constitute the partner nonrecourse deductions with respect to a partner nonrecourse debt must be made in a manner consistent with the provisions of paragraphs (c) and (j)(1) (i) and (iii) of this section.

(3) *Determination of partner nonrecourse debt minimum gain.* For any partnership taxable year, the determination of partner nonrecourse debt minimum gain and the net increase or decrease in partner nonrecourse debt minimum gain must be made in a manner consistent with the provisions of paragraphs (d) and (g)(3) of this section.

(4) *Chargeback of partner nonrecourse debt minimum gain.* If during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner nonrecourse debt minimum gain (determined under paragraph (i)(5) of this section) as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner's share of the net decrease in the partner nonrecourse debt minimum gain. A partner's share of the net decrease in partner nonrecourse debt minimum gain is determined in a manner consistent with the provisions of paragraph (g)(2) of this section. A partner is not subject to this minimum gain chargeback, however, to the extent the net decrease in partner nonrecourse debt minimum gain arises because the liability ceases to be partner nonrecourse debt due to a conversion, refinancing, or other change in the debt instrument that causes it to become partially or wholly a nonrecourse liability. The amount that would otherwise be subject to the partner nonrecourse debt minimum gain chargeback is added to the partner's share of partnership minimum gain under paragraph (g)(3) of this section. In addition, rules consistent with the provisions of paragraphs (f) (2), (3), (4), and (5) of this section apply with respect to partner nonrecourse debt in appropriate circumstances. The determination of which items of partnership income and gain must be allocated pursuant to this paragraph (i)(4) is made in a manner that is consistent with the provisions of paragraph (f)(6) of this section. See paragraph (j)(2) (ii) and (iii) of this section for more specific rules.

(5) *Partner's share of partner nonrecourse debt minimum gain.* A partner's share of partner nonrecourse debt minimum gain at the end of any partnership taxable year is determined in a manner consistent with the provisions of paragraphs (g)(1) and (g)(3) of this section with respect to each particular partner nonrecourse debt for which the partner bears the economic risk of loss. For purposes of §1.704–1(b)(2)(ii)(*d*), a partner's share of partner nonrecourse debt minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore, and the partner is not otherwise considered to have a deficit restoration obligation as a result of bearing the economic risk of loss for any partner nonrecourse debt. See paragraph (m), *Example* (1)(viii) of this section.

(6) *Distribution of partner nonrecourse debt proceeds allocable to an increase in partner nonrecourse debt minimum gain.* Rules consistent with the provisions of paragraph (h) of this section apply to distributions of the proceeds of partner nonrecourse debt.

(j) *Ordering rules.* For purposes of this section, the following ordering rules apply to partnership items. Notwithstanding any other provision in this section and §1.704–1, allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations.

(1) *Treatment of partnership losses and deductions.* (i) *Partner nonrecourse deductions.* Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partner nonrecourse deductions in the amount determined under paragraph (i)(2) of this section (determining partner nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt;

(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to a partnership nonrecourse liability is first treated as a partnership nonrecourse deduction and any excess is treated as a partner nonrecourse deduction under this paragraph (j)(1)(i).

(ii) *Partnership nonrecourse deductions.* Partnership losses, deductions, and section 705(a)(2)(B) expenditures are treated as partnership nonrecourse deductions in the amount determined under paragraph (c) of this section (determining nonrecourse deductions) in the following order:

(A) First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt is first treated as a partner nonrecourse deduction and any excess is treated as a partnership nonrecourse deduction under this paragraph (j)(1)(ii). Any other item that is treated as a partner nonrecourse deduction will in no event be treated as a partnership nonrecourse deduction.

(iii) *Carryover to succeeding taxable year.* If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and section 705(a)(2)(B) expenditures for the taxable year (determined under paragraphs (j)(1) (i) and (ii) of this section), the excess is treated as an increase in partner nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year. See paragraph (m), *Example* (1)(vi) of this section.

(2) *Treatment of partnership income and gains.* (i) *Minimum gain chargeback.* Items of partnership income and gain equal to the minimum gain chargeback requirement (determined under paragraph (f) of this section) are allocated as a minimum gain chargeback in the following order:

(A) First, gain from the disposition of property subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to partner nonrecourse debt is allocated to satisfy a minimum gain chargeback requirement for partnership nonrecourse debt only to the extent not allocated under paragraph (j)(2)(ii) of this section.

(ii) *Chargeback attributable to decrease in partner nonrecourse debt minimum gain.* Items of partnership income and gain equal to the partner nonrecourse debt minimum gain chargeback (determined under paragraph (i)(4) of this section) are allocated to satisfy a partner nonrecourse debt minimum gain chargeback in the following order:

(A) First, gain from the disposition of property subject to partner nonrecourse debt;

(B) Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to a partnership nonrecourse liability is allocated to satisfy a partner nonrecourse debt minimum gain chargeback only to the extent not allocated under paragraph (j)(2)(i) of this section. An item of partnership income and gain that is allocated to satisfy a minimum gain chargeback under paragraph (f) of this section is not allocated to satisfy a minimum gain chargeback under paragraph (i)(4).

(iii) *Carryover to succeeding taxable year.* If a minimum gain chargeback requirement (determined under paragraphs (f) and (i)(4) of this section) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.

(k) *Tiered partnerships.* For purposes of this section, the following rules determine the effect on partnership minimum gain when a partnership (''upper-tier partnership'') is a partner in another partnership (''lower-tier partnership'').

(1) *Increase in upper-tier partnership's minimum gain.* The sum of the nonrecourse deductions that the lower-tier partnership allocates to the upper-tier partnership for any taxable year of the upper-tier partnership, and the distributions made during that taxable year from the lower-tier partnership to the upper-tier partnership of proceeds of nonrecourse debt that are allocable to an increase in the lower-tier partnership's minimum gain, is treated as an increase in the upper-tier partnership's minimum gain.

(2) *Decrease in upper-tier partnership's minimum gain.* The upper-tier partnership's share for its taxable year of the lower-tier partnership's net decrease in its minimum gain is treated as a decrease in the upper-tier partnership's minimum gain for that taxable year.

(3) *Nonrecourse debt proceeds distributed from the lower-tier partnership to the upper-tier partnership.* All distributions from the lower-tier partnership to the upper-tier partnership during the upper-tier partnership's taxable year of proceeds of a nonrecourse liability allocable to an increase in the lower-tier partnership's minimum gain are treated as proceeds of a nonrecourse liability of the upper-tier partnership. The increase in the upper-tier partnership's minimum gain (under paragraph (k)(1) of this section) attributable to the receipt of those distributions is, for purposes of paragraph (h) of this section, treated as an increase in the upper-tier partnership's minimum gain arising from encumbering property of the upper-tier partnership with a nonrecourse liability of the upper-tier partnership.

(4) *Nonrecourse deductions of lower-tier partnership treated as depreciation by upper-tier partnership.* For purposes of paragraph (c) of this section, all nonrecourse deductions allocated by the lower-tier partnership to the upper-tier partnership for the upper-tier partnership's taxable year are treated as depreciation or cost recovery deductions with respect to property owned by the upper-tier partnership and subject to a nonrecourse liability of the upper-tier partnership with respect to which minimum gain increased during the year by the amount of the nonrecourse deductions.

(5) *Coordination with partner nonrecourse debt rules.* The lower-tier partnership's liabilities that are treated as the upper-tier partnership's liabilities under §1.752–4(a) are treated as the upper-tier partnership's liabilities for purposes of applying paragraph (i) of this section. Rules consistent with the provisions of paragraphs (k)(1) through (k)(4) of this section apply to determine the allocations that the upper-tier partnership must make with respect to any liability that constitutes a nonrecourse debt for which one or more partners of the upper-tier partnership bear the economic risk of loss.

(l) *Effective dates*—(1) *In general*—(i) *Prospective application.* Except as otherwise provided in this paragraph (l), this section applies for partnership taxable years beginning on or after December 28, 1991. For the rules applicable to taxable years beginning after December 29, 1988, and before December 28, 1991, see former §1.704–1T(b)(4)(iv). For the rules applicable to taxable years beginning on or before December 29, 1988, see former §1.704–1(b)(4)(iv).

(ii) *Partnerships subject to temporary regulations.* If a partnership agreement entered into after December 29, 1988, and before December 28, 1991, or a partnership agreement entered into on or before December 29, 1988, that elected to apply former §1.704–1T(b)(4)(iv) (as contained in the CFR edition revised as of April 1, 1991), complied with the provisions of former §1.704–1T(b)(4)(iv) before December 28, 1991—

(A) The provisions of former §1.704–1T(b)(4)(iv) continue to apply to the partnership for any taxable year beginning on or after December 28, 1991, (unless the partnership makes an election under paragraph (l)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(iii) *Partnerships subject to former regulations.* If a partnership agreement entered into on or before December 29, 1988, complied with the provisions of former §1.704–1(b)(4)(iv)(*d*) on or before that date—

(A) The provisions of former §1.704–1(b)(4)(iv) (*a*) through (*f*) continue to apply to the partnership for any taxable year beginning after that date (unless the partnership made an election under § 1.704–1T(b)(4)(iv)(*m*)(*4*) in a partnership taxable year ending before December 28, 1991, or makes an election under paragraph (l)(4) of this section) and ending before any subsequent material modification to the partnership agreement; and

(B) The provisions of this section do not apply to the partnership for any of those taxable years.

(2) *Special rule applicable to pre-January 30, 1989, related party nonrecourse debt.* For purposes of this section and former § 1.704–1T(b)(4)(iv), if—

(i) A partnership liability would, but for this paragraph (l)(2) of this section, constitute a partner nonrecourse debt; and

(ii) Sections 1.752–1 through 1.752–3 or former §§ 1.752–1T through –3T (whichever is applicable) do not apply to the liability;

the liability is, notwithstanding paragraphs (i) and (b)(4) of this section, treated as a nonrecourse liability of the partnership, and not as a partner nonrecourse debt, to the extent the liability would be so treated under this section (or § 1.704–1T(b)(4)(iv)) if the determination of the extent to which one or more partners bears the economic risk of loss for the liability under § 1.752–1 or former § 1.752–1T were made without regard to the economic risk of loss that any partner would otherwise be considered to bear for the liability by reason of any obligation undertaken or interest as a creditor acquired prior to January 30, 1989, by a person related to the partner (within the meaning of § 1.752–4(b) or former § 1.752–1T(h)). For purposes of the preceding sentence, if a related person undertakes an obligation or acquires an interest as a creditor on or after January 30, 1989, pursuant to a written binding contract in effect prior to January 30, 1989, and at all times thereafter, the obligation or interest as a creditor is treated as if it were undertaken or acquired prior to January 30, 1989. However, for partnership taxable years beginning on or after December 29, 1988, a pre-January 30, 1989, liability, other than a liability subject to paragraph (l)(3) of this section or former § 1.704–1T(b)(4)(iv)(*m*)(*3*) (whichever is applicable), that is treated as grandfathered under former §§ 1.752–1T through –3T (whichever is applicable) will be treated as a nonrecourse liability for purposes of this section provided that all partners in the partnership consistently treat the liability as nonrecourse for partnership taxable years beginning on or after December 29, 1988.

(3) *Transition rule for pre-March 1, 1984, partner nonrecourse debt.* If a partnership liability would, but for this paragraph (l)(3) or former § 1.704–1T(b)(4)(iv), constitute a partner nonrecourse debt and the liability constitutes grandfathered partner nonrecourse debt that is appropriately treated as a nonrecourse liability of the partnership under § 1.752–1 (as in effect prior to December 29, 1988)—

(i) The liability is, notwithstanding paragraphs (i) and (b)(4) of this section, former § 1.704–1T(b)(4)(iv), and former § 1.704–1(b)(4)(iv), treated as a nonrecourse liability of the partnership for purposes of this section and for purposes of former § 1.704–1T(b)(4)(iv) and former § 1.704–1(b)(4)(iv) to the extent of the amount, if any, by which the smallest outstanding balance of the liability during the period beginning at the end of the first partnership taxable year ending on or after December 31, 1986, and ending at the time of any determination under this paragraph (l)(3)(i) or former § 1.704–1T(b)(4)(iv)(*m*)(*3*)(*i*) exceeds the aggregate amount of the adjusted basis (or book value) of partnership property allocable to the liability (determined in accordance with former § 1.704–1(b)(4)(iv)(*c*) (*1*) and (*2*) at the end of the first partnership taxable year ending on or after December 31, 1986); and

(ii) In applying this section to the liability, former § 1.704–1(b)(4)(iv)(*c*) (*1*) and (*2*) is applied as if all of the adjusted basis of partnership property allocable to the liability is allocable to the portion of the liability that is treated as a partner nonrecourse debt and as if none of the adjusted basis of partnership property that is allocable to the liability is allocable to the portion of the liability that is treated as a nonrecourse liability under this paragraph (l)(3) and former § 1.704–1T (b)(4)(iv)(*m*)(*3*)(*i*).

For purposes of the preceding sentence, a grandfathered partner debt is any partnership liability that was not subject to former §§ 1.752–1T and –3T but that would have been subject to those sections under § 1.752–4T(b) if the liability had arisen (other than pursuant to a written binding contract) on or after March 1, 1984. A partnership liability is not considered to have been subject to §§ 1.752–2T and –3T solely because a portion of the liability was treated as a liability to which those sections apply under § 1.752–4(e).

(4) *Election.* A partnership may elect to apply the provisions of this section to the first taxable year of the partnership ending on or after December 28, 1991. An election under this paragraph (l)(4) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and must declare that an election is made under this paragraph (l)(4).

(m) *Examples.* The principles of this section are illustrated by the following examples:

Example 1. Nonrecourse deductions and partnerships minimum gain. For *Example* 1, unless otherwise provided, the following facts are assumed. LP, the limited partner, and GP, the general partner, form a limited partnership to acquire and operate a commercial office building. LP contributes $180,000, and GP contributes $20,000. The partnership obtains an $800,000 nonrecourse loan and purchases the building (on leased land) for $1,000,000. The nonrecourse loan is secured only by the building, and no principal payments are due for 5 years. The partnership agreement provides that GP will be required to restore any deficit balance in GP's capital account following the liquidation of GP's interest (as set forth in § 1.704–1 (b) (2)(ii)(*b*)(*3*)), and LP will not be required to restore any deficit balance in LP's capital account following the liquidation of LP's interest. The partnership agreement contains the following provisions required by paragraph (e) of this section: a qualified income offset (as defined in § 1.704–1(b)(2)(ii)(*d*)); a minimum gain chargeback (in accordance with paragraph (f) of this section); a provision that the partners' capital accounts will be determined and maintained in accordance with § 1.704–1(b)(2)(ii)(*b*)(*1*); and a provision that distributions will be made in accordance with partners' positive capital account balances (as set forth in § 1.704–1(b)(2)(ii)(*b*)(*2*)). In addition, as of the end of each partnership taxable year discussed herein, the items described in § 1.704–1(b)(2)(ii)(*d*) (*4*), (*5*), and (*6*) are not reasonably expected to cause or increase a deficit balance in LP's capital account. The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made 90 percent to LP and 10 percent to GP until a total of $200,000 has been distributed, and thereafter all the distributions will be made equally to LP and GP. In each of the partnership's first 2 taxable years, it generates rental income of $95,000, operating expenses (including land lease payments) of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000 in each of those years. The allocations of these losses 90 per percent to LP and 10 percent to GP have substantial economic effect.

	LP	GP
Capital account on formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Capital account at end of year 2	$27,000	$3,000

In the partnership's third taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in net taxable loss of $85,000. The partnership makes no distributions.

(i) *Calculation of nonrecourse deductions and partnership minimum gain.* If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of the third year, it would realize $70,000 of gain ($800,000 amount realized less $730,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of the third year (and the net increase in partnership minimum gain during the year) is $70,000, there are partnership nonrecourse deductions for that year of $70,000, consisting of depreciation deductions allowable with respect to the building of $70,000. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of

$85,000, including the $70,000 nonrecourse deduction, are allocated 90 percent to LP and 10 percent to GP. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	LP	GP
Capital account at end of year 2	$27,000	$3,000
Less: net loss in year 3 (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 3	(63,000)	(7,000)
Capital account at end of year 3	($49,500)	($5,500)

The allocation of the $70,000 nonrecourse deduction satisfies requirement (2) of paragraph (e) of this section because it is consistent with allocations having substantial economic effect of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, LP's and GP's shares of partnership minimum gain are $63,000 and $7,000, respectively. Therefore, pursuant to paragraph (g)(1) of this section, LP is treated as obligated to restore a deficit capital account balance of $63,000, so that in the succeeding year LP could be allocated up to an additional $13,500 of partnership deductions, losses, and section 705(a)(2)(B) items that are not nonrecourse deductions. Even though this allocation would increase a deficit capital account balance, it would be considered to have economic effect under the alternate economic effect test contained in §1.704–1(b)(2)(ii)(*d*). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the beginning of the partnership's fourth taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero, and the minimum gain chargeback would require that LP and GP be allocated $63,000 and $7,000, respectively, of the gain from that disposition.

(ii) *Illustration of reasonable consistency requirement.* Assume instead that the partnership agreement provides that all nonrecourse deductions of the partnership will be allocated equally between LP and GP. Furthermore, at the time the partnership agreement is entered into, there is a reasonable likelihood that over the partnership's life it will realize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions). The equal allocation of excess income and gain has substantial economic effect.

	LP	GP
Capital account on formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Less: net loss in year (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 3	(35,000)	(35,000)
Capital account at end of year 3	($21,500)	($33,500)

The allocation of the $70,000 nonrecourse deduction equally between LP and GP satisfies requirement (2) of paragraph (e) of this section because the allocation is consistent with allocations, which will have substantial economic effect, of other significant partnership items attributable to the building. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners' interests in the partnership. The allocation of the nonrecourse deductions 75 percent to LP and 25 percent to GP (or in any other ratio between 90 percent to LP/10 percent to GP and 50 percent to LP/50 percent to GP) also would satisfy requirement (2) of paragraph (e) of this section.

(iii) *Allocation of nonrecourse deductions that fails reasonable consistency requirement.* Assume instead that the partnership agreement provides that LP will be allocated 99 percent, and GP 1 percent, of all nonrecourse deductions of the partnership. Allocating nonrecourse deductions this way does not satisfy requirement (2) of paragraph (e) of this section because the allocations are not reasonably consistent with allocations, having substantial economic effect, of any other significant partnership item attributable to the building. Therefore, the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners' overall economic interests in the partnership, determined under §1.704–1(b)(3)(ii).

(iv) *Capital contribution to pay down nonrecourse debt.* At the beginning of the partnership's fourth taxable year, LP contributes $144,000 and GP contributes $16,000 of additional capital to the partnership, which the partnership immediately uses to reduce the amount of its nonrecourse liability from $800,000 to $640,000. In addition, in the partnership's fourth taxable year, it generates rental income of $95,000, operating expenses of $10,000, interest expense of $64,000 (consistent with the debt reduction), and a depreciation deduction of $90,000, resulting in a net taxable loss of $69,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($640,000 amount realized less $640,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of the year is zero, which represents a net decrease in partnership minimum gain of $70,000 during the year. LP's and GP's shares of this net decrease are $63,000 and $7,000 respectively, so that at the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are zero. Although there has been a net decrease in partnership minimum gain, pursuant to paragraph (f)(3) of this section LP and GP are not subject to a minimum gain chargeback.

	LP	GP
Capital account at end of year 3	($49,500)	($5,500)
Plus: contribution	144,000	16,000
Less: net loss in year 4	(62,100)	(6,900)
Capital account at end of year 4	$32,400	$3,600
Minimum gain chargeback carryforward	$0	$0

(v) *Loans of unequal priority.* Assume instead that the building acquired by the partnership is secured by a $700,000 nonrecourse loan and a $100,000 recourse loan, subordinate in priority to the nonrecourse loan. Under paragraph (d)(2) of this section, 700,000 of the adjusted basis of the building at the end of the partnership's third taxable year is allocated to the nonrecourse liability (with the remaining $30,000 allocated to the recourse liability) so that if the partnership disposed of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($700,000 amount realized less $700,000 adjusted tax basis). Therefore, there is no minimum gain (or increase in minimum gain) at the end of the partnership's third taxable year. If, however, the $700,000 nonrecourse loan were subordinate in priority to the $100,000 recourse loan, under paragraph (d)(2) of this section, the first $100,000 of adjusted tax basis in the building would be allocated to the recourse liability, leaving only $630,000 of the adjusted basis of the building to be allocated to the $700,000 nonrecourse loan. In that case, the balance of the $700,000 nonrecourse liability would exceed the adjusted tax basis of the building by $70,000, so that there would be $70,000 of minimum gain (and a $70,000 increase in partnership minimum gain) in the partnership's third taxable year.

(vi) *Nonrecourse borrowing; distribution of proceeds in subsequent year.* The partnership obtains an additional nonrecourse loan of $200,000 at the end of its fourth taxable year, secured by a second mortgage on the building, and distributes $180,000 of this cash to its partners at the beginning of its fifth taxable year. In addition, in its fourth and fifth taxable years, the partnership again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000 ($100,000 in the fifth taxable year reflecting the interest paid on both liabilities), and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000 ($105,000 in the fifth taxable year reflecting the interest paid on both liabilities). The partnership has distributed its $5,000 of operating cash flow in each year ($95,000 of rental income less $10,000 of operating expense and $80,000 of interest expense) to LP and GP at the end of each year. If the partnership were to dispose of the building in full satisfaction of both nonrecourse liabilities at the end of its fourth taxable year, the partnership would realize $360,000 of gain ($1,000,000 amount realized less $640,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during the partnership's fourth taxable year is $290,000 ($360,000 of minimum gain at the end of the fourth year less $70,000 of minimum gain at the end of the third year). Because the partnership did not distribute any of the proceeds of the loan it obtained in its fourth year during that year, the potential amount of partnership nonrecourse deductions for that year is $290,000. Under paragraph (c) of this section, if the partnership had distributed the proceeds of that loan to its partners at the end of its fourth year, the partnership's nonrecourse deductions for that year would have been reduced by the amount of that distribution because the proceeds of that loan are allocable to an increase in partnership minimum gain under paragraph (h)(1) of this section. Because the nonrecourse deductions of $290,000 for the partnership's fourth taxable year exceed its total deductions for that year, all $180,000 of the partnership's deductions for that year are treated as nonrecourse deductions, and the $110,000 excess nonrecourse deductions are treated as an increase in partnership minimum gain in the partnership's fifth taxable year under paragraph (c) of this section.

	LP	GP
Capital account at end of year 3 (including cash flow distributions)	($63,000)	($7,000)
Plus: rental income in year 4	85,500	9,500
Less: nonrecourse deductions in year 4	(162,000)	(18,000)
Less: cash flow distributions in year 4	(4,500)	(500)
Capital account at end of year 4	($144,000)	($16,000)

At the end of the partnership's fourth taxable year, LP's and GP's shares of partnership minimum gain are $225,000 and $25,000, respectively (because the $110,000 excess of nonrecourse deductions is carried forward to the next year). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liabilities at the end of its fifth taxable year, the partnership would realize $450,000 of gain ($1,000,000 amount realized less $550,000 adjusted tax basis). Therefore, the net increase in partnership minimum gain during the partnership's fifth taxable year is $200,000 ($110,000 deemed increase plus the $90,000 by which minimum gain at the end of the fifth year exceeds minimum gain at the end of the fourth year ($450,000 less $360,000)). At the beginning of its fifth year, the partnership distributes $180,000 of the loan proceeds (retaining $20,000 to pay the additional interest expense). Under paragraph (h) of this section, the first $110,000 of this distribution (an amount equal to the deemed increase in partnership minimum gain for the year) is considered allocable to an increase in partnership minimum gain for the year. As a result, the amount of nonrecourse deductions for the partnership's fifth taxable year is $90,000 ($200,000 net increase in minimum gain less $110,000 distribution of nonrecourse liability proceeds allocable to an increase in partnership minimum gain), and the nonrecourse deductions consist solely of the $90,000 depreciation deduction allowable with respect to the building. As a result of the distributions during the partnership's fifth taxable year, the total distributions to the partners over the partnership's life equal $205,000. Therefore, the last $5,000 distributed to the partners during the fifth year will be divided equally between them under the partnership agreement. Thus, out of the $185,000 total distribution during the partnership's fifth taxable year, the first $180,000 is distributed 90 percent to LP and 10 percent to GP, and the last $5,000 is divided equally between them.

	LP	GP
Capital account at end of year 4	($144,000)	($16,000)
Less: net loss in year 5 (without nonrecourse deductions)	(13,500)	(1,500)
Less: nonrecourse deductions in year 5	(81,000)	(9,000)
Less: distribution of loan proceeds	(162,000)	(18,000)
Less: cash flow distribution in year 5	(2,500)	(2,500)
Capital account at end of year 5	($403,000)	($47,000)

At the end of the partnership's fifth taxable year, LP's share of partnership minimum gain is $405,000 ($225,000 share of minimum gain at the end of the fourth year plus $81,000 of nonrecourse deductions for the fifth year and a $99,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain) and GP's share of partnership minimum gain is $45,000 ($25,000 share of minimum gain at the end of the fourth year plus $9,000 of nonrecourse deductions for the fifth year and an $11,000 distribution of nonrecourse liability proceeds that are allocable to an increase in minimum gain).

(vii) *Partner guarantee of nonrecourse debt.* LP and GP personally guarantee the ''first'' $100,000 of the $800,000 nonrecourse loan (*i.e.*, only if the building is worth less than $100,000 will they be called upon to make up any deficiency). Under paragraph (d)(2) of this section, only $630,000 of the adjusted tax basis of the building is allocated to the $700,000 nonrecourse portion of the loan because the collateral will be applied first to satisfy the $100,000 guaranteed portion, making it superior in priority to the remainder of the loan. On the other hand, if LP and GP were to guarantee the ''last'' $100,000 (*i.e.*, if the building is worth less than $800,000, they will be called upon to make up the deficiency up to $100,000), $700,000 of the adjusted tax basis of the building would be allocated to the $700,000 nonrecourse portion of the loan because the guaranteed portion would be inferior in priority to it.

(viii) *Partner nonrecourse debt.* Assume instead that the $800,000 loan is made by LP, the limited partner. Under paragraph (b)(4) of this section, the $800,000 obligation does not constitute a nonrecourse liability of the partnership for purposes of this section because LP, a partner, bears the economic risk of loss for that loan within the meaning of §1.752–2. Instead, the $800,000 loan constitutes a partner nonrecourse debt under paragraph (b)(4) of this section. In the partnership's third taxable year, partnership minimum gain would have increased by $70,000 if the debt were a nonrecourse liability of the partnership. Thus, under paragraph (i)(3) of this section, there is a net increase of $70,000 in the minimum gain attributable to the $800,000 partner nonrecourse debt for the partnership's third taxable year, and $70,000 of the $90,000 depreciation deduction from the building for the partnership's third taxable year constitutes a partner nonrecourse deduction with respect to the debt. See paragraph (i)(4) of this section. Under paragraph (i)(2) of this section, this partner nonrecourse deduction must be allocated to LP, the partner that bears the economic risk of loss for that liability.

(ix) *Nonrecourse debt and partner nonrecourse debt of differing priorities.* As in *Example* 1 (viii) of this paragraph (m), the $800,000 loan is made to the partnership by LP, the limited partner, but the loan is a purchase money loan that ''wraps around'' a $700,000 underlying nonrecourse note (also secured by the building) issued by LP to an unrelated person in connection with LP's acquisition of the building. Under these circumstances, LP bears the economic risk of loss with respect to only $100,000 of the liability within the meaning of §1.752–2. See §1.752–2(f) (*Example* 6). Therefore, for purposes of paragraph (d) of this section, the $800,000 liability is treated as a $700,000 nonrecourse liability of the partnership and a $100,000 partner nonrecourse debt (inferior in priority to the $700,000 liability) of the partnership for which LP bears the economic risk of loss. Under paragraph (i)(2) of this section, $70,000 of the $90,000 depreciation deduction realized in the partnership's third taxable year constitutes a partner nonrecourse deduction that must be allocated to LP.

Example. 2. *Netting of increases and decreases in partnership minimum gain.* For *Example* 2 unless otherwise provided, the following facts are assumed. X and Y form a general partnership to acquire and operate residential real properties. Each partner contributes $150,000 to the partnership. The partnership obtains a $1,500,000 nonrecourse loan and purchases 3 apartment buildings (on leased land) for $720,000 (''Property A''), $540,000 (''Property B''), and $540,000 (''Property C''). The nonrecourse loan is secured only by the 3 buildings, and no principal payments are due for 5 years. In each of the partnership's first 3 taxable years, it generates rental income of $225,000, operating expenses (including land lease payments) of $50,000, interest expense of $175,000, and depreciation deductions on the 3 properties of $150,000 ($60,000 on Property A and $45,000 on each of Property B and Property C), resulting in a net taxable loss of $150,000 in each of those years. The partnership makes no distributions to X or Y.

(i) *Calculation of net increases and decreases in partnership minimum gain.* If the partnership were to dispose of the 3 apartment buildings in full satisfaction of its nonrecourse liability at the end of its third taxable year, it would realize $150,000 of gain ($1,500,000 amount realized less $1,350,000 adjusted tax basis). Because the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is $150,000, the amount of partnership nonrecourse deductions for that year is $150,000, consisting of depreciation deductions allowable with respect to the 3 apartment buildings of $150,000. The result would be the same if the partnership obtained 3 separate nonrecourse loans that were ''cross-collateralized'' (*i.e.*, if each separate loan were secured by all 3 of the apartment buildings).

(ii) *Netting of increases and decreases in partnership minimum gain when there is a disposition.* At the beginning of the partnership's fourth taxable year, the partnership (with the permission of the nonrecourse lender) disposes of Property A for $835,000 and uses a portion of the proceeds to repay $600,000 of the nonrecourse liability (the principal amount attributable to Property A), reducing the balance to $900,000. As a result of the disposition, the partnership realizes gain of $295,000 ($835,000 amount realized less $540,000 adjusted tax basis). If the disposition is viewed in isolation, the partnership has generated minimum gain of $60,000 on the sale of Property A ($600,000 of debt reduction less $540,000 adjusted tax basis). However, during the partnership's fourth taxable year it also generates rental income of $135,000, operating expenses of $30,000, interest expense of $105,000, and depreciation deductions of $90,000 ($45,000 on each remaining building). If the partnership were to dispose of the remaining two buildings in full satisfaction of its nonrecourse liability at the end of the partnership's fourth taxable year, it would realize gain of $180,000 ($900,000 amount realized less $720,000 aggregate adjusted tax basis), which is the amount of partnership minimum gain at the end of the year. Because the partnership minimum gain increased from $150,000 to $180,000 during the partnership's fourth taxable year, the amount of partnership nonrecourse deductions for that year is $30,000, consisting of a ratable portion of depreciation deductions allowable with respect to the two remaining apartment buildings. No minimum gain chargeback is required for the taxable year, even though the partnership disposed of one of the properties subject to the nonrecourse liability during the year, because there is no net decrease in partnership minimum gain for the year. See paragraph (f)(1) of this section.

Example. 3. *Nonrecourse deductions and partnership minimum gain before third partner is admitted.* For purposes of *Example 3*, unless otherwise provided, the following facts are assumed. Additional facts are given in each of *Examples 3* (ii), (iii), and (iv). A and B form a limited partnership to acquire and lease machinery that is 5-year recovery property. A, the limited partner, and B, the general partner, contribute $100,000 each to the partnership, which obtains an $800,000 nonrecourse loan and purchases the machinery for $1,000,000. The nonrecourse loan is secured only by the machinery. The principal amount of the loan is to be repaid $50,000 per year during each of the partnership's first 5 taxable years, with the remaining $550,000 of unpaid principal due on the first day of the partnership's sixth taxable year. The partnership agreement contains all of the provisions required by paragraph (e) of this section, and, as of the end of each partnership taxable year discussed herein, the items described in §1.704–1(b)(2)(ii)(*d*) (*4*), (*5*), and (*6*) are not reasonably expected to cause or increase a deficit balance in A's or B's capital account. The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated equally between A and B. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made equally between A and B. In the partnership's first taxable year it generates rental income of $130,000, interest expense of $80,000, and a depreciation deduction of $150,000, resulting in a net taxable loss of $100,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $750,000. Allocations of these losses equally between A and B have substantial economic effect.

	A	B
Capital account on formation	$100,000	$100,000
Less: net loss in year 1	(50,000)	(50,000)
Capital account at end of year 1	$50,000	$50,000

In the partnership's second taxable year, it generates rental income of $130,000, interest expense of $75,000, and a depreciation deduction of $220,000, resulting in a net taxable loss of $165,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $700,000, and distributes $2,500 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of that year, it would realize $70,000 of gain ($700,000 amount realized less $630,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during the year) is $70,000, and the amount of partnership nonrecourse deductions for the year is $70,000. The partnership nonrecourse deductions for its second taxable year consist of $70,000 of the depreciation deductions allowable with respect to the machinery. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of $165,000, including the $70,000 nonrecourse deduction, are allocated equally between A and B. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	A	B
Capital account at end of year 1	$50,000	$50,000
Less: net loss in year 2 (without nonrecourse deductions)	(47,500)	(47,500)
Less: nonrecourse deductions in year 2	(35,000)	(35,000)
Less: distribution	(2,500)	(2,500)
Capital account at end of year 2	($35,000)	($35,000)

(i) *Calculation of nonrecourse deductions and partnership minimum gain.* Because all of the requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's second taxable year, A's and B's shares of partnership minimum gain are $35,000 each. Therefore, pursuant to paragraph (g)(1) of this section, A and B are treated as obligated to restore deficit balances in their capital accounts of $35,000 each. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the beginning of the partnership's third taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero. A's and B's shares of that net decrease would be $35,000 each. Upon that disposition, the minimum gain chargeback would require that A and B each be allocated $35,000 of that gain before any other allocation is made under section 704 (b) with respect to partnership items for the partnership's third taxable year.

(ii) *Nonrecourse deductions and restatement of capital accounts.* (a) *Additional facts.* C is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of C's admission, the fair market value of the machinery is $900,000. C contributes $100,000 to the partnership (the partnership invests $95,000 of this in undeveloped land and holds the other $5,000 in cash) in exchange for an interest in the partnership. In connection with C's admission to the partnership, the partnership's machinery is revalued on the partnership's books to reflect its fair market value of $900,000. Pursuant to §1.704–1(b)(2)(iv)(*f*), the capital accounts of A and B are adjusted upwards to $100,000 each to reflect the revaluation of the partnership's machinery. This adjustment reflects the manner in which the partnership gain of $270,000 ($900,000 fair market value minus $630,000 adjusted tax basis) would be shared if the machinery were sold for its fair market value immediately prior to C's admission to the partnership.

	A	B
Capital account before C's admission	($35,000)	($35,000)
Deemed sale adjustment	135,000	135,000
Capital account adjusted for C's admission	$100,000	$100,000

The partnership agreement is modified to provide that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deduction, as computed for book purposes, are allocated equally among the partners, and those allocations are reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the machinery will be shared among the partners in a manner that takes account of the variation between the property's $630,000 adjusted tax basis and its $900,000 book value, in accordance with §1.704–1(b)(2)(iv)(*f*) and the special rule contained in §1.704–1(b)(4)(i).

(b) *Effect of revaluation.* Because the requirements of §1.704–1(b)(2)(iv)(*g*) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with §1.704–1(b)(2)(iv). If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability immediately following the revaluation of the machinery, it would realize no book gain ($700,000 amount realized less $900,000 book value). As a result of the revaluation of the machinery upward by $270,000, under part (i) of paragraph (d)(4) of this section, the partnership minimum gain is reduced from $70,000 immediately prior to the revaluation to zero; but under part (ii) of paragraph (d)(4) of this section, the partnership minimum gain is increased by the $70,000 decrease arising solely from the revaluation. Accordingly, there is no net increase or decrease solely on account of the revaluation, and so no minimum gain chargeback is triggered. All future nonrecourse deductions that occur will be the nonrecourse deductions as calculated for book purposes, and will be charged to all 3 partners in accordance with the partnership agreement. For purposes of determining the partners' shares of minimum gain under paragraph (g) of this section, A's and B's shares of the decrease resulting from the revaluation are $35,000 each. However, as illustrated below, under section 704(c) principles, the tax capital accounts of A and B will eventually be charged $35,000 each, reflecting their 50 percent shares of the decrease in partnership minimum gain that resulted from the revaluation.

(iii) *Allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Additional facts.* During the partnership's third taxable year, the partnership generates rental income of $130,000, interest expense of $70,000 a tax depreciation deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result, the partnership has a net taxable loss of $150,000 and a net book loss of $240,000. In addition, the partnership repays $50,000 of the nonrecourse liability (after the data of C's admission), reducing the liability to $650,000 and distributes $5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, $50,000 of book gain would result ($650,000 amount realized less $600,000 book basis). Therefore, the amount of partnership minimum gain at the end of the year is $50,000, which represents a net decrease in partnership minimum gain of $20,000 during the year. (This is so even though there would be an increase in partnership minimum gain in the partnership's third taxable year if minimum gain were computed with reference to the adjusted tax basis of the machinery.) Nevertheless, pursuant to paragraph (d)(4) of this section, the amount of nonrecourse deductions of the partnership for its third taxable year is $50,000 (the net increase in partnership minimum gain during the year determined by adding back the $70,000 decrease in partnership minimum gain attributable to the revaluation of the machinery to the $20,000 net decrease in partnership minimum gain during the year). The $50,000 of partnership nonrecourse deductions for the year consist of book depreciation deductions allowable with respect to the machinery of $50,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of $240,000, including the $50,000 nonrecourse deduction, are allocated equally among the partners. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in §1.704–1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of $210,000 for the partnership's third taxable year is, in accordance with section 704(c) principles, shared $55,000 to A, $55,000 to B, and $100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	($35,000)	$100,000	($35,000)	$100,0000	$100,000	$100,000
Less: nonrecourse deductions	(9,166)	(16,666)	(9,166)	(16,666)	(16,666)	(16,666)
Less: items other than nonrecourse deductions in year 3	(25,834)	(63,334)	(25,834)	(63,334)	(63,334)	(63,334)
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 3	($75,000)	$15,000	($75,000)	$15,000	$15,000	$15,000

Because the requirements of paragraph (e) of this section are satisfied, the allocation of the nonrecourse deduction is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, A's, B's, and C's shares of partnership minimum gain are $16,666 each.

(iv) *Subsequent allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the second and third taxable years of the partnership are as stated in *Example* 3(iii) of this paragraph (m). In addition, during the partnership's fourth taxable year the partnership generates rental income of $130,000, interest expense of

$65,000, a tax depreciation deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result, the partnership has a net taxable loss of $145,000 and a net book loss of $235,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $600,000, and distributes $5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the fourth year, $300,000 of book gain would result ($600,000 amount realized less $300,000 book value). Therefore, the amount of partnership minimum gain as of the end of the year is $300,000, which represents a net increase in partnership minimum gain during the year of $250,000. Thus, the amount of partnership nonrecourse deductions for that year equals $250,000, consisting of book depreciation deductions of $250,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of $235,000, including the $250,000 nonrecourse deduction, are allocated equally among the partners. That allocation of all items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in §1.704–1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of $210,000 in the partnership's fourth taxable year is, in accordance with section 704(c) principles, allocated $55,000 to A, $55,000 to B, and $100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end year 3	($75,000)	$15,000	($75,000)	$15,000	$15,000	$15,000
Less: nonrecourse deductions	(45,833)	(83,333)	(45,833)	(83,333)	(83,333)	(83,333)
Plus: items other than nonrecourse deduction in year 4	12,499	5,000	12,499	5,000	5,000	5,000
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 4	($113,334)	($68,333)	($113,333)	($68,333)	($68,333)	($68,333)

The allocation of the $250,000 nonrecourse deduction equally among A, B, and C satisfies requirement (2) of paragraph (e) of this section. Because all of the requirements of paragraph (e) of this section are satisfied, the allocation is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's fourth taxable year, A's, B's, and C's shares of partnership minimum gain are $100,000 each.

(v) *Disposition of partnership property following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the fourth taxable year of the partnership are as stated above in (iv). In addition, at the beginning of the partnership's fifth taxable year it sells the machinery for $650,000 (using $600,000 of the proceeds to repay the nonrecourse liability), resulting in a taxable gain of $440,000 ($650,000 amount realized less $210,000 adjusted tax basis) and a book gain of $350,000 ($650,000 amount realized less $300,000 book basis). The partnership has no other items of income, gain, loss, or deduction for the year.

(b) *Effect of disposition.* As a result of the sale, partnership minimum gain is reduced from $300,000 to zero, reducing A's, B's, and C's shares of partnership minimum gain to zero from $100,000 each. The minimum gain chargeback requires that A, B, and C each be allocated $100,000 of that gain (an amount equal to each partner's share of the net decrease in partnership minimum gain resulting from the sale) before any allocation is made to them under section 704(b) with respect to partnership items for the partnership's fifth taxable year. Thus, the allocation of the first $300,000 of book gain $100,000 to each of the partners is deemed to be in accordance with the partners' interests in the partnership under paragraph (e) of this section. The allocation of the remaining $50,000 of book gain equally among the partners has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in §1.704–1(b)(4)(i), the partnership agreement provides that the $440,000 taxable gain is, in accordance with section 704(c) principles, allocated $161,667 to A, $161,667 to B, and $116,666 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 4	($113,334)	($68,333)	($113,334)	($68,333)	($68,333)	($68,333)
Plus: minimum gain chargeback	138,573	100,000	138,573	100,000	100,000	100,000
Plus: additional gain	23,094	16,666	23,094	16,666	16,666	16,666

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account before liquidation	$48,333	$48,333	$48,333	$48,333	$48,333	$48,333

Example. 4. *Allocations of increase in partnership minimum gain among partnership properties.* For *Example* 4, unless otherwise provided, the following facts are assumed. A partnership owns 4 properties, each of which is subject to a nonrecourse liability of the partnership. During a taxable year of the partnership, the following events take place. First, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property W of $10,000 and repays $5,000 of the nonrecourse liability secured only by that property, resulting in an increase in minimum gain with respect to that liability of $5,000. Second, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property X of $10,000 and repays none of the nonrecourse liability secured by that property, resulting in an increase in minimum gain with respect to that liability of $10,000. Third, the partnership generates a depreciation deduction (for both book and tax purposes) of $2,000 with respect to Property Y and repays $11,000 of the nonrecourse liability secured only by that property, resulting in a decrease in minimum gain with respect to that liability of $9,000 (although at the end of that year, there remains minimum gain with respect to that liability). Finally, the partnership borrows $5,000 on a nonrecourse basis, giving as the only security for that liability Property Z, a parcel of undeveloped land with an adjusted tax basis (and book value) of $2,000, resulting in a net increase in minimum gain with respect to that liability of $3,000.

(i) *Allocation of increase in partnership minimum gain.* The net increase in partnership minimum gain during that partnership taxable year is $9,000, so that the amount of nonrecourse deductions of the partnership for that taxable year is $9,000. Those nonrecourse deductions consist of $3,000 of depreciation deductions with respect to Property W and $6,000 of depreciation deductions with respect to Property X. See paragraph (c) of this section. The amount of nonrecourse deductions consisting of depreciation deductions is determined as follows. With respect to the nonrecourse liability secured by Property Z, for which there is no depreciation deduction, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. Similarly, with respect to the nonrecourse liability secured by Property Y, for which there is no increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. With respect to each of the nonrecourse liabilities secured by Properties W and X, which are secured by property for which there are depreciation deductions and for which there is an increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is determined by the following formula:

net increase in the partnership minimum gain for that taxable year X total depreciation deductions for that taxable year on the specific property securing the nonrecourse liability to the extent minimum gain increased on that liability (divided by) total depreciation deductions for that taxable year on all properties securing nonrecourse liabilities to the extent of the aggregate increase in minimum gain on all those liabilities.

Thus, for the liability secured by Property W, the amount is $9,000 times $5,000/$15,000, or $3,000. For the liability secured by Property X, the amount is $9,000 times $10,000/ $15,000, or $6,000. (If one depreciable property secured two partnership nonrecourse liabilities, the amount of depreciation or book depreciation with respect to that property would be allocated among those liabilities in accordance with the method by which adjusted basis is allocated under paragraph (d)(2) of this section).

(ii) *Alternative allocation of increase in partnership minimum gain among partnership properties.* Assume instead that the loan secured by Property Z is $15,000 (rather than $5,000), resulting in a net increase in minimum gain with respect to that liability of $13,000. Thus, the net increase in partnership minimum gain is $19,000, and the amount of nonrecourse deductions of the partnership for that taxable year is $19,000. Those nonrecourse deductions consist of $5,000 of depreciation deductions with respect to Property W, $10,000 of depreciation deductions with respect to Property X, and a pro rata portion of the partnership's other items of deduction, loss, and section 705(a)(2)(B) expenditure for that year. The method for computing the amounts of depreciation deductions that constitute nonrecourse deductions is the same as in (i) of this *Example* 4 for the liabilities secured by Properties Y and Z. With respect to each of the nonrecourse liabilities secured by Properties W and X, the amount of depreciation deductions that constitutes nonrecourse deductions equals the total depreciation deductions with respect to the partnership property securing that particular liability to the extent of the increase in minimum gain with respect to that liability.

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§ 1.704–3 Contributed property.

(a) *In general*—(1) *General principles.* The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (e.g., aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See § 1.704–3(d). Paragraph (e) of this section contains special rules and exceptions.

(2) *Operating rules.* Except as provided in paragraphs (e)(2) and (e)(3) of this section, section 704(c) and this section apply on a property-by-property basis. Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated. A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of section 704(c). It may be unreasonable to use one method for appreciated property and another method for depreciated property. Similarly, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using curative allocations for built-in gain property contributed by a partner with a low marginal tax rate. A new partnership formed as the result of the termination of a partnership under section 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to section 704(c) property deemed contributed to the new partnership by the terminated partnership under § 1.708–1(b)(1)(iv). The previous sentence applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentence may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentence to the termination in a consistent manner.

(3) *Definitions*—(i) *Section 704(c) property*. Property contributed to a partnership is section 704(c) property if at the time of contribution its book value differs from the contributing partner's adjusted tax basis. For purposes of this section, book value is determined as contemplated by § 1.704–1(b). Therefore, book value is equal to fair market value at the time of contribution and is subsequently adjusted for cost recovery and other events that affect the basis of the property. For a partnership that maintains capital accounts in accordance with § 1.704–1(b)(2)(iv), the book value of property is initially the value used in determining the contributing partner's capital account under § 1.704–1(b)(2)(iv)(*d*), and is appropriately adjusted thereafter (e.g., for book cost recovery under §§ 1.704–1(b)(2)(iv)(*g*)(*3*) and

1.704–3(d)(2) and other events that affect the basis of the property). A partnership that does not maintain capital accounts under §1.704–1(b)(2)(iv) must comply with this section using a book capital account based on the same principles (i.e., a book capital account that reflects the fair market value of property at the time of contribution and that is subsequently adjusted for cost recovery and other events that affect the basis of the property). Property deemed contributed to a new partnership as the result of the termination of a partnership under section 708(b)(1)(B) is treated as section 704(c) property in the hands of the new partnership only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination. See §1.708–1(b)(1)(iv) for an example of the application of this rule. The previous two sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(ii) *Built-in gain and built-in loss.* The built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis. The built-in loss on section 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution. The built-in loss is thereafter reduced by decreases in the difference between the property's adjusted tax basis and book value.

(4) *Accounts payable and other accrued but unpaid items.* Accounts payable and other accrued but unpaid items contributed by a partner using the cash receipts and disbursements method of accounting are treated as section 704(c) property for purposes of applying the rules of this section.

(5) *Other provisions of the Internal Revenue Code.* Section 704(c) and this section apply to a contribution of property to the partnership only if the contribution is governed by section 721, taking into account other provisions of the Internal Revenue Code. For example, to the extent that a transfer of property to a partnership is a sale under section 707, the transfer is not a contribution of property to which section 704(c) applies.

(6) *Other applications of section 704(c) principles*—(i) *Revaluations under section 704(b).* The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704–1(b)(2)(iv)(*f*) (reverse section 704(c) allocations). Partnerships are not required to use the same allocation method for reverse section 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to section 704(c) and paragraph (a) of this section. In addition, partnerships are not required to use the same allocation method for reverse section 704(c) allocations each time the partnership revalues its property. A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of section 704(b) and (c).

(ii) *Basis adjustments.* A partnership making adjustments under §1.743–1(b) or 1.751–1(a)(2) must account for built-in gain or loss under section 704(c) in accordance with the principles of this section.

(7) *Transfers of a partnership interest.* If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.

(8) *Disposition of property in nonrecognition transaction.* If a partnership disposes of section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as section 704(c) property with the

same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property. If a partnership transfers an item of section 704(c) property together with other property to a corporation under section 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the section 704(c) property is determined as if each item of section 704(c) property had been the only property transferred to the corporation by the partnership.

(9) *Tiered partnerships.* If a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), or if a partner that has contributed section 704(c) property to a partnership contributes that partnership interest to a second partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Allocations made under this paragraph will be considered to be made in a manner that meets the requirements of §1.704–1(b)(2)(iv)(*q*) (relating to capital account adjustments where guidance is lacking).

(10) *Anti-abuse rule.* An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

(11) *Contributing and noncontributing partners' recapture shares.* For special rules applicable to the allocation of depreciation recapture with respect to property contributed by a partner to a partnership, see §§1.1245–1(e)(2) and 1.1250–1(f).

(b) *Traditional method*—(1) *In general.* This paragraph (b) describes the traditional method of making section 704(c) allocations. In general, the traditional method requires that when the partnership has income, gain, loss, or deduction attributable to section 704(c) property, it must make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss. Under this rule, if the partnership sells section 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner. If the partnership sells a portion of, or an interest in, section 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner. For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners. However, the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule). If a partnership has no property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed property.

(2) *Examples.* The following examples illustrate the principles of the traditional method.

Example 1. Operation of the traditional method—(i) *Calculation of built-in gain on contribution.* A and B form partnership AB and agree that each will be allocated a 50 percent share of all partnership items and that AB will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. A contributes depreciable property with an adjusted tax basis of $4,000 and a book value of $10,000, and B contributes $10,000 cash. Under paragraph (a)(3) of this section, A has built-in gain of $6,000, the excess of the partnership's book value for the property ($10,000) over A's adjusted tax basis in the property at the time of contribution ($4,000).

(ii) *Allocation of tax depreciation.* The property is depreciated using the straight-line method over a 10-year recovery period. Because the property depreciates at an annual rate of 10 percent, B would have been entitled to a depreciation deduction of $500 per year for both book and tax purposes if the adjusted tax basis of the property equalled its fair market value at the time of contribution. Although each partner is allocated $500 of book depreciation per year, the partnership is allowed a tax depreciation deduction of only $400 per year (10 percent of $4,000). The partnership can allocate only $400 of tax depreciation under the ceiling rule of paragraph (b)(1) of this section, and it must be allocated entirely to B. In AB's first year, the proceeds generated by the equipment exactly equal AB's operating expenses. At the end of that year, the book value of the property is $9,000 ($10,000 less the $1,000 book depreciation deduction), and the adjusted tax basis is $3,600 ($4,000 less the $400 tax depreciation deduction). A's built-in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). Also, at the end of AB's first year, A has a $9,500 book capital account and a $4,000 tax basis in A's partnership interest. B has a $9,500 book capital account and a $9,600 adjusted tax basis in B's partnership interest.

(iii) *Sale of the property.* If AB sells the property at the beginning of AB's second year for $9,000, AB realizes tax gain of $5,400 ($9,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, the entire $5,400 gain must be allocated to A because the property A contributed has that much built-in gain remaining. If AB sells the property at the beginning of AB's second year for $10,000, AB realizes tax gain of $6,400 ($10,000, the amount realized, less the adjusted tax basis of $3,600). Under paragraph (b)(1) of this section, only $5,400 of gain must be allocated to A to account for A's built-in gain. The remaining $1,000 of gain is allocated equally between A and B in accordance with the partnership agreement. If AB sells the property for less than the $9,000 book value, AB realizes tax gain of less than $5,400, and the entire gain must be allocated to A.

(iv) *Termination and liquidation of partnership.* If AB sells the property at the beginning of AB's second year for $9,000, and AB engages in no other transactions that year, A will recognize a gain of $5,400, and B will recognize no income or loss. A's adjusted tax basis for A's interest in AB will then be $9,400 ($4,000, A's original tax basis, increased by the gain of $5,400). B's adjusted tax basis for B's interest in AB will be $9,600 ($10,000, B's original tax basis, less the $400 depreciation deduction in the first partnership year). If the partnership then terminates and distributes its assets ($19,000 in cash) to A and B in proportion to their capital account balances, A will recognize a capital gain of $100 ($9,500, the amount distributed to A, less $9,400, the adjusted tax basis of A's interest). B will recognize a capital loss of $100 (the excess of B's adjusted tax basis, $9,600, over the amount received, $9,500).

Example 2. Unreasonable use of the traditional method—(i) *Facts.* C and D form partnership CD and agree that each will be allocated a 50 percent share of all partnership items and that CD will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. C contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer. At the time of contribution, C has a built-in gain of $9,000 and the equipment is section 704(c) property. D contributes $10,000 of cash, which CD uses to buy securities. D has substantial net operating loss carryforwards that D anticipates will otherwise expire unused. Under §1.704–1(b)(2)(iv)(*g*)(3), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership's first year. CD sells the equipment during the second year for $10,000 and recognizes a $10,000 gain ($10,000, the amount realized, less the adjusted tax basis of $0).

(ii) *Unreasonable use of method*—(A) At the beginning of the second year, both the book value and adjusted tax basis of the equipment are $0. Therefore, there is no remaining built-in gain. The $10,000 gain on the sale of the equipment in the second year is allocated $5,000 each to C and D. The interaction of the partnership's one-year write-off of the entire book value of the equipment and the use of the traditional method results in a shift of $4,000 of the precontribution gain in the equipment from C to D (D's $5,000 share of CD's $10,000 gain, less the $1,000 tax depreciation deduction previously allocated to D).

(B) The traditional method is not reasonable under paragraph (a)(10) of this section because the contribution of property is made, and the traditional method is used, with a view to shifting a significant amount of taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate.

(C) Under these facts, if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated first to C to offset the effect of the ceiling rule limitation, the allocation method would not violate the anti-abuse rule of paragraph (a)(10) of this section. See paragraph (c)(3) of this section. Under other facts, (for example, if the partnership holds multiple section 704(c) properties and either uses multiple allocation methods or uses a single allocation method where one or more of the properties are subject to the ceiling rule) the allocation to C may not be reasonable.

(c) *Traditional method with curative allocations*—(1) *In general.* To correct distortions created by the ceiling rule, a partnership using the traditional method under paragraph (b) of this section may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. For example, if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of section 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding book depreciation is allocated to the contributing partner. A partnership may limit its curative allocations to allocations of one or more particular tax items (e.g., only depreciation from a specific property or properties) even if the allocation of those available items does not offset fully the effect of the ceiling rule.

(2) *Consistency*. A partnership must be consistent in its application of curative allocations with respect to each item of section 704(c) property from year to year.

(3) *Reasonable curative allocations*—(i) *Amount.* A curative allocation is not reasonable to the extent it exceeds the amount necessary to offset the effect of the ceiling rule for the current taxable year or, in the case of a curative allocation upon disposition of the property, for prior taxable years.

(ii) *Timing.* The period of time over which the curative allocations are made is a factor in determining whether the allocations are reasonable. Notwithstanding paragraph (c)(3)(i) of this section, a partnership may make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year if those allocations are made over a reasonable period of time, such as over the property's economic life, and are provided for under the partnership agreement in effect for the year of contribution. See paragraph (c)(4) *Example 3* (ii)(C) of this section.

(iii) *Type*—(A) *In general.* To be reasonable, a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. The expectation must exist at the time the section 704(c) property is obligated to be (or is) contributed to the partnership and the allocation with respect to that property becomes part of the partnership agreement. However, the expectation is tested at the time the allocation with respect to that property is actually made if the partnership agreement is not sufficiently specific as to the precise manner in which allocations are to be made with respect to that property. Under this paragraph (c), if the item limited by the ceiling rule is loss from the sale of property, a curative allocation of gain must be expected to have substantially the same effect as would an allocation to that partner of gain with respect to the sale of the property. If the item limited by the ceiling rule is depreciation or other cost recovery, a curative allocation of income to the contributing partner must be expected to have substantially the same effect as would an allocation to that partner of partnership income with respect to the contributed property. For example, if depreciation deductions with respect to leased equipment contributed by a tax-exempt partner are limited by the ceiling rule, a curative allocation of dividend or interest income to that partner generally is not reasonable, although a curative allocation of depreciation deductions from other leased equipment to the noncontributing partner is reasonable. Similarly, under this rule, if depreciation deductions apportioned to foreign source income in a particular statutory grouping under section 904(d) are limited by the ceiling rule, a curative allocation of income from another statutory grouping to the contributing partner generally is not reasonable, although a curative allocation of income from the same statutory grouping and of the same character is reasonable.

(B) *Exception for allocation from disposition of contributed property.* If cost recovery has been limited by the ceiling rule, the general limitation on character does not apply to income from the disposition of contributed property subject to the ceiling rule, but only if properly provided for in the partnership agreement in effect for the year of contribution or revaluation. For example, if allocations of depreciation deductions to a noncontributing partner have been limited by the ceiling rule, a curative allocation to the contributing partner of gain from the sale of that property, if properly provided for in the partnership agreement, is reasonable for purposes of paragraph (c)(3)(iii)(A) of this section even if not of the same character.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. Reasonable and unreasonable curative allocations—(i) *Facts.* E and F form partnership EF and agree that each will be allocated a 50 percent share of all partnership items and that EF will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. E contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The equipment has 10 years remaining on its cost recovery schedule and is depreciable using the straight-line method. At the time of contribution, E has a built-in gain of $6,000, and therefore, the equipment is section 704(c) property. F contributes $10,000 of cash, which EF uses to buy inventory for resale. In EF's first year, the revenue generated by the equipment equals EF's operating expenses. The equipment generates $1,000 of book depreciation and $400 of tax depreciation for each of 10 years. At the end of the first year EF sells all the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment. Under the traditional method of paragraph (b) of this section, E and F would each be allocated $350 of income from the sale of inventory for book and tax purposes and $500 of depreciation for book purposes. The $400 of tax depreciation would all be allocated to F. Thus, at the end of the first year, E and F's book and tax capital accounts would be as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	350	350	350	Sales income.
9,850	4,350	9,850	9,950	

(ii) *Reasonable curative allocation.* Because the ceiling rule would cause a disparity of $100 between F's book and tax capital accounts, EF may properly allocate to E under paragraph (c) of this section an additional $100 of income from the sale of inventory for tax purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	450	350	250	Sales income.
9,850	4,450	9,850	9,850	

(iii) *Unreasonable curative allocation.* (A) The facts are the same as in paragraphs (i) and (ii) of this *Example 1,* except that E and F choose to allocate all the income from the sale of the inventory to E for tax purposes, although they share it equally for book purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		F		
Book	Tax	Book	Tax	
$10,000	$4,000	$10,000	$10,000	Initial contribution.
<500>	<0>	<500>	<400>	Depreciation.
350	700	350	0	Sales income.
9,850	4,700	9,850	9,600	

(B) This curative allocation is not reasonable under paragraph (c)(3)(i) of this section because the allocation exceeds the amount necessary to offset the disparity caused by the ceiling rule.

Example 2. Curative allocations limited to depreciation—(i) *Facts.* G and H form partnership GH and agree that each will be allocated a 50 percent share of all partnership items and that GH will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section, but only to the extent that the partnership has sufficient tax depreciation deductions. G contributes property G1, with an adjusted tax basis of $3,000 and a fair market value of $10,000, and H contributes property H1, with an adjusted tax basis of $6,000 and a fair market value of $10,000. Both properties have 5 years remaining on their cost recovery schedules and are depreciable using the straight-line method. At the time of contribution, G1 has a built-in gain of $7,000 and H1 has a built-in gain of $4,000, and therefore, both properties are section 704(c) property. G1 generates $600 of tax depreciation and $2,000 of book depreciation for each of five years. H1 generates $1,200 of tax depreciation and $2,000 of book depreciation for each of 5 years. In addition, the properties each generate $500 of operating income annually. G and H are each allocated $1,000 of book depreciation for each property. Under the traditional method of paragraph (b) of this section, G would be allocated $0 of tax depreciation for G1 and $1,000 for H1, and H would be allocated $600 of tax depreciation for G1 and $200 for H1. Thus, at the end of the first year, G and H's book and tax capital accounts would be as follows:

G		H		
Book	Tax	Book	Tax	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<1,000>	<1,000>	<200>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,500	8,500	5,700	

(ii) *Curative allocations.* Under the traditional method, G is allocated more depreciation deductions than H, even though H contributed property with a smaller disparity reflected on GH's book and tax capital accounts. GH makes curative allocations to H of an additional $400 of tax depreciation each year, which reduces the disparities between G and H's book and tax capital accounts ratably each year. These allocations are reasonable provided the allocations meet the other requirements of this section. As a result of their agreement, at the end of the first year, G and H's capital accounts are as follows:

G		H		
Book	Tax	Book	Tax	
$10,000	$3,000	$10,000	$6,000	Initial contribution.
<1,000>	<0>	<1,000>	<600>	G1 depreciation.
<1,000>	<600>	<1,000>	<600>	H1 depreciation.
500	500	500	500	Operating income.
8,500	2,900	8,500	5,300	

Example 3. Unreasonable use of curative allocations—(i) *Facts.* J and K form partnership JK and agree that each will receive a 50 percent share of all partnership items and that JK will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. J contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of

the fact that the equipment has only one year remaining on its cost recovery schedule although it has an estimated remaining economic life of 10 years. J has substantial net operating loss carryforwards that J anticipates will otherwise expire unused. At the time of contribution, J has a built-in gain of $9,000, and therefore, the equipment is section 704(c) property. K contributes $10,000 of cash, which JK uses to buy inventory for resale. In JK's first year, the revenues generated by the equipment exactly equal JK's operating expenses. Under § 1.704–1(b)(2)(iv)(*g*)(*3*), the partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership's first year. In addition, at the end of the first year JK sells all of the inventory for $18,000, recognizing $8,000 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from J's contributed equipment. Under the traditional method of paragraph (b) of this section, J and K's book and tax capital accounts at the end of the first year would be as follows:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,000	4,000	4,000	Sales income.
9,000	5,000	9,000	13,000	

(ii) *Unreasonable use of method*. (A) The use of curative allocations under these facts to offset immediately the full effect of the ceiling rule would result in the following book and tax capital accounts at the end of JK's first year:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	8,000	4,000	0	Sales income.
9,000	9,000	9,000	9,000	

(B) This curative allocation is not reasonable under paragraph (a)(10) of this section because the contribution of property is made and the curative allocation method is used with a view to shifting a significant amount of partnership taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate, within a period of time significantly shorter than the economic life of the property.

(C) The property has only one year remaining on its cost recovery schedule even though its economic life is considerably longer. Under these facts, if the partnership agreement had provided for curative allocations over a reasonable period of time, such as over the property's economic life, rather than over its remaining cost recovery period, the allocations would have been reasonable. See paragraph (c)(3)(ii) of this section. Thus, in this example, JK would make a curative allocation of $400 of sales income to J in the partnership's first year (10 percent of $4,000). J and K's book and tax capital accounts at the end of the first year would be as follows:

J		K		
Book	Tax	Book	Tax	
$10,000	$1,000	$10,000	$10,000	Initial contribution.
<5,000>	<0>	<5,000>	<1,000>	Depreciation.
4,000	4,400	4,000	3,600	Sales income.
9,000	5,400	9,000	12,600	

(d) *Remedial allocation method*—(1) *In general*. A partnership may adopt the remedial allocation method described in this paragraph to eliminate distortions caused by the ceiling rule. A partnership adopting the remedial allocation method eliminates those distortions by creating remedial items and allocating those items to its partners. Under the remedial allocation method, the partnership first determines the amount of book items under paragraph (d)(2) of this section and the partners' distributive shares of these items under section 704(b). The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method described in paragraph (b)(1) of this section. If the ceiling rule (as defined in paragraph (b)(1) of this section) causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.

(2) *Determining the amount of book items.* Under the remedial allocation method, a partnership determines the amount of book items attributable to contributed property in the following manner rather than under the rules of § 1.704–1(b)(2)(iv)(*g*)(*3*). The portion of the partnership's book basis in the property equal to the adjusted tax basis in the property at the time of contribution is recovered in the same manner as the adjusted tax basis in the property is recovered (generally, over the property's remaining recovery period under section 168(i)(7) or other applicable Internal Revenue Code section). The remainder of the partnership's book basis in the property (the amount by which book basis exceeds adjusted tax basis) is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution.

(3) *Type.* Remedial allocations of income, gain, loss, or deduction to the noncontributing partner have the same tax attributes as the tax item limited by the ceiling rule. The tax attributes of offsetting remedial allocations of income, gain, loss, or deduction to the contributing partner are determined by reference to the item limited by the ceiling rule. Thus, for example, if the ceiling rule limited item is loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be gain from the sale of that property. Conversely, if the ceiling rule limited item is gain from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be loss from the sale of that property. If the ceiling rule limited item is depreciation or other cost recovery from the contributed property, the offsetting remedial allocation to the contributing partner must be income of the type produced (directly or indirectly) by that property. Any partner level tax attributes are determined at the partner level. For example, if the ceiling rule limited item is depreciation from property used in a rental activity, the remedial allocation to the noncontributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity. Each partner then applies section 469 to the allocations as appropriate.

(4) *Effect of remedial items*—(i) *Effect on partnership.* Remedial items do not affect the partnership's computation of its taxable income under section 703 and do not affect the partnership's adjusted tax basis in partnership property.

(ii) *Effect on partners.* Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners' book capital accounts. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest.

(5) *Limitations on use of methods involving remedial allocations*—(i) *Limitation on taxpayers.* In the absence of published guidance, the remedial allocation method described in this paragraph (d) is the only reasonable section 704(c) method permitting the creation of notional tax items.

(ii) *Limitation on Internal Revenue Service.* In exercising its authority under paragraph (a)(10) of this section to make adjustments if a partnership's allocation method is not reasonable, the Internal Revenue Service will not require a partnership to use the remedial allocation method described in this paragraph (d) or any other method involving the creation of notional tax items.

(6) *Adjustments to application of method.* The Commissioner may, by published guidance, prescribe adjustments to the remedial allocation method under this paragraph (d) as necessary or appropriate. This guidance may, for example, prescribe adjustments to the remedial allocation method to prevent the duplication or omission of items of income or deduction or to reflect more clearly the partners' income or the income of a transferee of a partner.

(7) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. Remedial allocation method—(i) *Facts.* On January 1, L and M form partnership LM and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that LM will make allocations under section 704(c) using the remedial allocation method under this paragraph (d) and that the straight-line method will be used to recover excess book basis. L contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes $10,000, which the partnership uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year the partnership is formed.

(ii) *Years 1 through 4.* Under the remedial allocation method of this paragraph (d), LM has book depreciation for each of its first 4 years of $1,600 [$1,000 ($4,000 adjusted tax basis divided by the 4-year remaining recovery period) plus $600 ($6,000 excess of book value over tax basis, divided by the *new* 10-year recovery period)]. (For the purpose of simplifying the example, the partnership's book depreciation is determined without regard to any first-year depreciation conventions.) Under the partnership agreement, L and M are each allocated 50 percent ($800) of the book depreciation. M is allocated $800 of tax depreciation and L is allocated the remaining $200 of tax depreciation ($1,000–$800). See paragraph (d)(1) of this section. No remedial allocations are made because the ceiling rule does not result in a book allocation of depreciation to M different from the tax allocation. The allocations result in capital accounts at the end of LM's first 4 years as follows:

	L		M	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$4,000	$10,000	$10,000
Depreciation	<3,200>	<800>	<3,200>	<3,200>
	$6,800	$3,200	$6,800	$6,800

(iii) *Subsequent years.* (A) For each of years 5 through 10, LM has $600 of book depreciation ($6,000 excess of initial book value over adjusted tax basis divided by the 10-year recovery period that commented in year 1), but no tax depreciation. Under the partnership agreement, the $600 of book depreciation is allocated equally to L and M. Because of the application of the ceiling rule in year 5, M would be allotted $300 of book depreciation, but no tax depreciation. Thus, at the end of LM's fifth year L's and M's book and tax capital accounts would be as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>		<300>	
	$6,500	$3,200	$6,500	$6,800

(B) Because the ceiling rule would cause an annual disparity of $300 between M's allocations of book and tax depreciation, LM must make remedial allocations of $300 of tax depreciation deductions to M under the remedial allocation method for each of years 5 through 10. LM must also make an offsetting remedial allocation to L of $300 of taxable income, which must be of the same type as income produced by the property. At the end of year 5, LM's capital accounts are as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 4	$6,800	$3,200	$6,800	$6,800
Depreciation	<300>	....	<300>	....
Remedial allocations	....	300	....	<300>
	$6,500	$3,500	$6,500	$6,500

(C) At the end of year 10, LM's capital accounts are as follows:

	L		M	
	Book	Tax	Book	Tax
End of year 5	$6,500	$3,500	$6,500	$6,500
Depreciation	<1,500>	....	<1,500>	....
Remedial allocations	....	1,500	....	<1,500>
	$5,000	$5,000	$5,000	$5,000

Example 2. Remedial allocations on sale—(i) *Facts.* N and P form partnership NP and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that NP will make allocations under section 704(c) using the remedial allocation method under this paragraph (d). N contributes Blackacre (land) with an adjusted tax basis of $4,000 and a fair market value of $10,000. Because N has a built-in gain of $6,000, Blackacre is section 704(c) property. P contributes Whiteacre (land) with an adjusted tax basis and fair market value of $10,000. At the end of NP's first year, NP sells Blackacre to Q for $9,000 and recognizes a capital gain of $5,000 ($9,000 amount realized less $4,000 adjusted tax basis) and a book loss of $1,000 ($9,000 amount realized less $10,000 book basis). NP has no other items of income, gain, loss, or deduction. If the ceiling rule were applied, N would be allocated the entire $5,000 of tax gain and N and P would each be allocated $500 of book loss. Thus, at the end of NP's first year N's and P's book and tax capital accounts would be as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	....
	$9,500	$9,000	$9,500	$10,000

(ii) *Remedial allocation.* Because the ceiling rule would cause a disparity of $500 between P's allocation of book and tax loss, NP must make a remedial allocation of $500 of capital loss to P and an offsetting remedial allocation to N of an additional $500 of capital gain. These allocations result in capital accounts at the end of NP's first year as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<500>	5,000	<500>	....
Remedial allocations	....	500	....	<500>
	$9,500	$9,500	$9,500	$9,500

Example 3. Remedial allocation where built-in gain property sold for book and tax loss—(i) *Facts.* The facts are the same as in Example 2, except that at the end of NP's first year, NP sells Blackacre to Q for $3,000 and recognizes a capital loss of $1,000 ($3,000 amount realized less $4,000 adjusted tax basis) and a book loss of $7,000 ($3,000 amount realized less $10,000 book basis). If the ceiling rule were applied, P would be allocated the entire $1,000 of tax loss and N and P would each be allocated $3,500 of book loss. Thus, at the end of NP's first year, N's and P's book and tax capital accounts would be as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
	$6,500	$4,000	$6,500	$9,000

(ii) *Remedial allocation.* Because the ceiling rule would cause a disparity of $2,500 between P's allocation of book and tax loss on the sale of Blackacre, NP must make a remedial allocation of $2,500 of capital loss to P and an offsetting remedial allocation to N of $2,500 of capital gain. These allocations result in capital accounts at the end of NP's first year as follows:

	N		P	
	Book	Tax	Book	Tax
Initial contribution	$10,000	$4,000	$10,000	$10,000
Sale of Blackacre	<3,500>	0	<3,500>	<1,000>
Remedial Allocations	....	2,500	....	<2,500>

	N		P	
	Book	Tax	Book	Tax
	$6,500	$6,500	$6,500	$6,500

(e) *Exceptions and special rules*—(1) *Small disparities*—(i) *General rule.* If a partner contributes one or more items of property to a partnership within a single taxable year of the partnership, and the disparity between the book value of the property and the contributing partner's adjusted tax basis in the property is a small disparity, the partnership may—

(A) Use a reasonable section 704(c) method;

(B) Disregard the application of section 704(c) to the property; or

(C) Defer the application of section 704(c) to the property until the disposition of the property.

(ii) *Definition of small disparity.* A disparity between book value and adjusted tax basis is a small disparity if the book value of all properties contributed by one partner during the partnership taxable year does not differ from the adjusted tax basis by more than 15 percent of the adjusted tax basis, and the total gross disparity does not exceed $20,000.

(2) *Aggregation.* Each of the following types of property may be aggregated for purposes of making allocations under section 704(c) and this section if contributed by one partner during the partnership taxable year.

(i) *Depreciable property.* All property, other than real property, that is included in the same general asset account of the contributing partner and the partnership under section 168.

(ii) *Zero-basis property.* All property with a basis equal to zero, other than real property.

(iii) *Inventory.* For partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets (as defined in paragraph (e)(3)(ii) of this section).

(3) *Special aggregation rule for securities partnerships*—(i) *General rule.* For purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of section 704(c). Notwithstanding paragraphs (a)(2) and (a)(6)(i) of this section, once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership. Paragraphs (e)(3)(iv) and (e)(3)(v) of this section describe approaches for aggregating reverse section 704(c) gains and losses that are generally reasonable. Other approaches may be reasonable in appropriate circumstances. See, however, paragraph (a)(10) of this section, which describes the circumstances under which section 704(c) methods, including the aggregate approaches described in this paragraph (e)(3), are not reasonable. A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property.

(ii) *Qualified financial assets*—(A) *In general.* A qualified financial asset is any personal property (including stock) that is actively traded. Actively traded means actively traded as defined in §1.1092(d)–1 (defining actively traded property for purposes of the straddle rules).

(B) *Management companies.* For a management company, qualified financial assets also include the following, even if not actively traded: shares of stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

(C) *Partnership interests.* An interest in a partnership is not a qualified financial asset for purposes of this paragraph (e)(3)(ii). However, for purposes of this paragraph (e)(3), a partnership (upper-tier partnership) that holds an interest in a securities partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and qualified financial assets as follows:

(*1*) In determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and

(*2*) If the upper-tier partnership adopts an aggregate approach under this paragraph (e)(3), the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

(iii) *Securities partnership*—(A) *In general.* A partnership is a securities partnership if the partnership is either a management company or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).

(B) *Definitions*—(*1*) *Management company.* A partnership is a management company if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

(*2*) *Investment partnership.* A partnership is an investment partnership if:

(*i*) On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90 percent of the fair market value of the partnership's non-cash assets; and

(*ii*) The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this paragraph (e)(3), to make revaluations at least annually.

(iv) *Partial netting approach.* This paragraph (e)(3)(iv) describes the partial netting approach of making reverse section 704(c) allocations. See Example 1 of paragraph (e)(3)(ix) of this section for an illustration of the partial netting approach. To use the partial netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the partial netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and

(C) Separately allocates the aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

(v) *Full netting approach.* This paragraph (e)(3)(v) describes the full netting approach of making reverse section 704(c) allocations on an aggregate basis. See Example 2 of paragraph (e)(3)(ix) of this section for an illustration of the full netting approach. To use the full netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the full netting approach, on the date of each capital account restatement, the partnership:

(A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;

(B) Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and

(C) Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

(vi) *Type of tax gain or loss.* The character and other tax attributes of gain or loss allocated to the partners under this paragraph (e)(3) must:

(A) Preserve the tax attributes of each item of gain or loss realized by the partnership;

(B) Be determined under an approach that is consistently applied; and

(C) Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

(vii) *Disqualified securities partnerships.* A securities partnership that adopts an aggregate approach under this paragraph (e)(3) and subsequently fails to qualify as a securities partnership must make reverse section 704(c) allocations on an asset-by-asset basis after the date of disqualification. The partnership, however, is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse section 704(c) allocations on or after the date of disqualification.

(viii) *Transitional rule for qualified financial assets revalued after effective date.* A securities partnership revaluing its qualified financial assets pursuant to §1.704–1(b)(2)(iv)(*f*) on or after the effective date of this section may use any reasonable approach to coordinate with revaluations that occurred prior to the effective date of this section.

(ix) *Examples.* The following examples illustrate the principles of this paragraph (e)(3).

Example 1. Operation of the partial netting approach—(i) *Facts.* Two regulated investment companies, X and Y, each contribute $150,000 in cash to form PRS, a partnership that registers as a management company. The partnership agreement provides that book items will be allocated in accordance with the partners' relative book capital accounts, that book capital accounts will be adjusted to reflect daily revaluations of property pursuant to §1.704–1(b)(2)(iv)(*f*)(*5*)(*iii*), and that reverse section 704(c) allocations will be made using the partial netting approach described in paragraph (e)(3)(iv) of this section. X and Y each have an initial book capital account of $150,000. In addition, the partnership establishes for each of X and Y a revaluation account with a beginning balance of $0. On Day 1, PRS buys Stock 1, Stock 2, and Stock 3 for $100,000 each. On Day 2, Stock 1 increases in value from $100,000 to $102,000, Stock 2 increases in value from $100,000 to $105,000, and Stock 3 declines in value from $100,000 to $98,000. At the end of Day 2, Z, a regulated investment company, joins PRS by contributing $152,500 in cash for a one-third interest in the partnership [$152,500 divided by $300,000 (initial values of stock) +$5,000 (net gain at end of Day 2)+ $152,500]. PRS uses this cash to purchase Stock 4. PRS establishes a revaluation account for Z with a $0 beginning balance. As of the close of Day 3, Stock 1 increases in value from $102,000 to $105,000, and Stocks 2, 3, and 4 decrease in value from $105,000 to $102,000, from $98,000 to $96,000, and from $152,500 to $151,500, respectively. At the end of Day 3, PRS sells Stocks 2 and 3.

(ii) *Book allocations—Day 2.* At the end of Day 2, PRS revalues the partnership's qualified financial assets and increases X's and Y's book capital accounts by each partner's 50 percent share of the $5,000 ($2,000 + $5,000 − $2,000) net increase in the value of the partnership's assets during Day 2. PRS increases X's and Y's respective revaluation account balances by $2,500 each to reflect the amount by which each partner's book capital account increased on Day 2. Z's capital account is not affected because Z did not join PRS until the end of Day 2. At the beginning of Day 3, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	....
Day 2 Adjustment	2,000	5,000	(2,000)	....
Total	$102,000	$105,000	$98,000	$152,500

	X		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing Balance	$152,500	$150,000	$2,500

	Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Closing balance	$152,500	$150,000	$2,500

	Z		
	Book	Tax	Revaluation account
Opening Balance	....	....	....
Day 2 Adjustment	....	....	....
Closing Balance	$152,500	$152,500	$0

(iii) *Book and tax allocations—Day 3.* At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the $3,000 ($3,000—$3,000—$2,000—$1,000) net decrease in the value of the partnership's qualified financial assets. PRS also reduces each partner's revaluation account balance by $1,000. Accordingly, X's and Y's revaluation account balances are reduced to $1,500 each and Z's revaulation account balance is ($1,000). PRS then separately allocates the tax gain from the sale of Stock 2 and the tax loss from the sale of Stock 3. The $2,000 of tax gain recognized on the sale of Stock 2 ($102,000—$100,000) is allocated among the partners with positive revaluation account balances in accordance with the relative balances of those revaluation accounts. X's and Y's revaluation accounts have equal positive balances; thus, PRS allocates $1,000 of the gain from the sale of Stock 2 to X and $1,000 of that gain to Y. PRS allocates none of the gain from the sale to Z because Z's revaluation account balance is negative. The $4,000 of tax loss recognized from the sale of Stock 3 ($96,000—$100,000) is allocated first to the partners with negative revaluation account balances to the extent of those balances. Because Z is the only partner with a negative revaluation account balance, the tax loss is allocated first to Z to the extent of Z's ($1,000) balance. The remaining $3,000 of tax loss is allocated among the partners in accordance with their distributive shares of the loss. Accordingly, PRS allocates $1,000 of tax loss from the sale of Stock 3 to each of X and Y. PRS also allocates an additional $1,000 of the tax loss to Z, so that Z's total share of the tax loss from the sale of Stock 3 is $2,000. PRS then reduces each partner's revaluation account balance by the amount of any tax gain allocated to that partner and increases each partner's revaluation account balance by the amount of any tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	
Day 3 Adjustment	$3,000	(3,000)	(2,000)	(1,000)
Total	$105,000	$102,000	$96,000	$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$150,000	$1,500
Gain from Stock 2	0	$1,000	(1,000)
Loss from Stock 3	0	($1,000)	1,000
Closing Balance	$151,500	$150,000	$1,500

	Z		
	Book	Tax	Revaluation account
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Gain from Stock 2	0	0	0
Loss from Stock 3	0	(2,000)	2,000
Closing Balance	$151,500	$150,500	$1,000

Example 2. Operation of the full netting approach—(i) *Facts.* The facts are the same as in Example 1, except that the partnership agreement provides that PRS will make reverse section 704(c) allocations using the full netting approach described in paragraph (e)(3)(v) of this section.

(ii) *Book allocations—Days 2 and 3.* PRS allocates its book gains and losses in the manner described in paragraphs (ii) and (iii) of Example 1 (the partial netting approach). Thus, at the end of Day 2, PRS increases the book capital accounts of X and Y by $2,500 to reflect the appreciation in the parntership's assets from the close of Day 1 to the close of Day 2 and records that increase in the revaluation account created for each partner. At the end of Day 3, PRS decreases the book capital accounts of X, Y, and Z by $1,000 to reflect each partner's share of the decline in value of the partnership's assets from Day 2 to Day 3 and reduces each partner's revaluation account by a corresponding amount.

(iii) *Tax allocations—Day 3.* After making the book adjustments described in the previous paragraph, PRS allocates its net tax gain (or net tax loss) from its sales of qualified financial assets during Day 3. To do so, PRS first determines its net tax gain (or net tax loss) recognized from its sales of qualified financial assets for the day. There is a $2,000 net tax loss ($2,000 gain from the sale of Stock 2 less $4,000 loss from the sale of Stock 3) on the sale of PRS's qualified financial assets. Because Z is the only partner with a negative revaluation account balance, the partnership's net tax loss is allocated first to Z to the extent of Z's ($1,000) revaluation account balance. The remaining net tax loss is allocated among the partners in accoradnce with their distributive shares of loss. Thus, PRS allocates $333.33 of the $2,000 net tax loss to each of X and Y. PRS also allocates an additional $333.33 of the net tax loss to Z, so that the total net tax loss allocation to Z is $1,333.33. PRS then increases each partner's revaluation account balance by the amount of net tax loss allocated to that partner. At the beginning of Day 4, the partnership's accounts are as follows:

	Stock 1	Stock 2	Stock 3	Stock 4
Opening Balance	$100,000	$100,000	$100,000	$152,500
Day 2 Adjustment	2,000	5,000	(2,000)	
Day 3 Adjustment	3,000	(3,000)	(2,000)	($1,000)
Total	$105,000	$102,000	$96,000	$151,500

	X and Y		
	Book	Tax	Revaluation account
Opening Balance	$150,000	$150,000	0
Day 2 Adjustment	$2,500	0	$2,500
Day 3 Adjustment	(1,000)	0	(1,000)
Total	$151,500	$150,000	$1,500
Net Tax Loss-Stocks 2 & 3	0	(333)	333
Closing Balance	$151,500	$149,667	$1,833

	Z		
	Book	Tax	Revaluation account
Opening Balance	$152,500	$152,500	0
Day 3 Adjustment	(1,000)	0	($1,000)
Total	$151,500	$152,500	($1,000)
Net Tax Loss-Stocks 2 & 3	0	(1,333)	1,333
Closing Balance	$151,500	$151,167	$333

(4) *Aggregation as permitted by the Commissioner.* The Commissioner may, by published guidance or by letter ruling, permit:

(i) Aggregation of properties other than those described in paragraphs (e)(2) and (e)(3) of this section;

(ii) Partnerships and partners not described in paragraph (e)(3) of this section to aggregate gain and loss from qualified financial assets; and

(iii) Aggregation of qualified financial assets for purposes of making section 704(c) allocations in the same manner as that described in paragraph (e)(3) of this section.

(f) *Effective date.* With the exception of paragraph (a)(11) of this section, this section applies to properties contributed to a partnership and to restatements pursuant to §1.704–1(b)(2)(iv)*(f)* on or after December 21, 1993. Paragraph (a)(11) of this section applies to properties contributed by a partner to a partnership on or after August 20, 1997. However, partnerships may rely on paragraph (a)(11) of this section for properties contributed before August 20, 1997 and disposed of on or after August 20, 1997.

[T.D. 8500, 58 FR 67679, Dec. 22, 1993; 59 FR 4140, Jan. 28, 1994, as amended by T.D. 8585, 59 FR 66728, Dec. 28, 1994; 60 FR 11906, Mar. 3, 1995; T.D. 8717, 62 FR 25500, May 9, 1997; T.D. 8730, 62 FR 44215, Aug. 20, 1997]

§ 1.704–4 Distribution of contributed property.

(a) *Determination of gain and loss*—(1) *In general.* A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its contribution to the partnership in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and §1.704–3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See §1.704–3(a)(3)(i) for a definition of section 704(c) property.

(2) *Transactions to which section 704(c)(1)(B) applies.* Section 704(c)(1)(B) and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731.

(3) *Fair market value of property.* The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct,

provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) *Determination of five-year period*—(i) *General rule.* The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) *Section 708(b)(1)(B) terminations.* A termination of the partnership under section 708(b)(1)(B) does not begin a new five-year period for each partner with respect to the built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under §1.708–1(b)(1)(iv). See §1.704–3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property. This paragraph (a)(4)(ii) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a)(4)(ii) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a)(4)(ii) to the termination in a consistent manner.

(5) *Examples.* The following examples illustrate the rules of this paragraph (a). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example 1. Recognition of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. Thus, there is a built-in gain of $6,000 on Property A at the time of contribution. B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C's interest in the partnership.

(iii) A would have recognized $6,000 of gain under section 704(c)(1)(A) and §1.704–3 on the sale of Property A at the time of the distribution ($10,000 fair market value less $4,000 adjusted tax basis). As a result, A must recognize $6,000 of gain on the distribution of Property A to C. B would not have recognized any gain or loss under section 704(c)(1)(A) and §1.704–3 on the sale of Property B at the time of distribution because Property B was not section 704(c) property. As a result, B does not recognize any gain or loss on the distribution of Property B.

Example 2. Effect of post-contribution depreciation deductions. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of $30,000 and an adjusted tax basis of $20,000. Therefore, there is a built-in gain of $10,000 on Property A. B and C each contribute $30,000 cash. ABC uses the traditional method of making section 704(c) allocations described in §1.704–3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of $3,000 per year (10 percent of the $30,000 book basis), and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000). The partnership has a tax depreciation deduction of $2,000 per year (10 percent of the $20,000 tax basis in Property A). This $2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of the third year, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and the adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation). A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is $7,000 ($21,000 book value less $14,000 adjusted tax basis).

(iv) On December 31, 1997, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under section 704(c)(1)(A) and §1.704–3(b). Therefore, A recognizes $7,000 of gain on the distribution of Property A to B.

Example 3. Effect of remedial method. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000, and Property A2, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. B and C each contribute $20,000 cash. ABC uses the remedial method of making section 704(c) allocations described in §1.704–3(d) with respect to Property A1.

(ii) On December 31, 1998, when the fair market value of Property A1 has decreased to $7,000, Property A1 is distributed to C in a current distribution. If Property A1 had been sold by the partnership at the time of the distribution, ABC would have recognized the $2,000 of remaining built-in gain under section 704(c)(1)(A) on the sale (fair market value of $7,000 less $5,000 adjusted tax basis). All of this gain would have been allocated to A. ABC would also have recognized a book loss of $3,000 ($10,000 original book value less $7,000 current fair market value of the property). Book loss in the amount of $2,000 would have been allocated equally between B and C. Under the remedial method, $2,000 of tax loss would also have been allocated equally to B and C to match their share of the book loss. As a result, $2,000 of gain would also have been allocated to A as an offsetting remedial allocation. A would have recognized $4,000 of total gain under section 704(c)(1)(A) on the sale of Property A1 ($2,000 of section 704(c) recognized gain plus $2,000 remedial gain). Therefore, A recognizes $4,000 of gain on the distribution of Property A1 to C under this section.

(b) *Character of gain or loss*—(1) *General rule.* Gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.

(2) *Example.* The following example illustrates the rule of this paragraph (b). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Character of gain. (i) On January 1, 1995, A and B form partnership AB. A contributes $10,000 and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000, in exchange for a 25 percent interest in partnership capital and profits. B contributes $60,000 cash for a 75 percent interest in partnership capital and profits.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. Property A is used in a trade or business of B.

(iii) A would have recognized $6,000 of gain under section 704(c)(1)(A) on a sale of Property A at the time of the distribution (the difference between the fair market value ($10,000) and the adjusted tax basis ($4,000) of the property at that time). Because Property A is not a capital asset in the hands of Partner B and B holds more than 50 percent of partnership capital and profits, the character of the gain on a sale of Property A to B would have been ordinary income under section 707(b)(2). Therefore, the character of the gain to A on the distribution of Property A to B is ordinary income.

(c) *Exceptions*—(1) *Property contributed on or before October 3, 1989.* Section 704(c)(1)(B) and this section do not apply to property contributed to the partnership on or before October 3, 1989.

(2) *Certain liquidations.* Section 704(c)(1)(B) and this section do not apply to a distribution of an interest in section 704(c) property to a partner other than the contributing partner in a liquidation of the partnership if—

(i) The contributing partner receives an interest in the section 704(c) property contributed by that partner (and no other property); and

(ii) The built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704–3 on a sale of the contributed property to an unrelated party immediately before the distribution.

(3) *Section 708(b)(1)(B) terminations.* Section 704(c)(1)(B) and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of section 704(c) property by the new partnership to a partner of the new partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the terminated partnership would have been subject to section 704(c)(1)(B). See also § 1.737–2(a) for a similar rule in the context of section 737. This paragraph (c)(3) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (c)(3) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (c)(3) to the termination in a consistent manner.

(4) *Complete transfer to another partnership.* Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See § 1.737–2(b) for a similar rule in the context of section 737.

(5) *Incorporation of a partnership.* Section 704(c)(1)(B) and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See § 1.737–2(c) for a similar rule in the context of section 737.

(6) *Undivided interests.* Section 704(c)(1)(B) and this section do not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See § 1.737–2(d)(4) for the application of section 737 in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(7) *Example.* The following example illustrates the rule of paragraph (c)(2) of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. (i) On January 1, 1995, A and B form partnership AB, as equal partners. A contributes Property A, nondepreciable real property with a fair market value and adjusted tax basis of $20,000. B contributes Property B, nondepreciable real property with a fair market value of $20,000 and an adjusted tax basis of $10,000. Property B therefore has a built-in gain of $10,000 at the time of contribution.

(ii) On December 31, 1998, the partnership liquidates when the fair market value of Property A has not changed, but the fair market value of Property B has increased to $40,000.

(iii) In the liquidation, A receives Property A and a 25 percent interest in Property B. This interest in Property B has a fair market value of $10,000 to A, reflecting the fact that A was entitled to 50 percent of the $20,000 post-contribution appreciation in Property B. The partnership distributes to B a 75 percent interest in Property B with a fair market value of $30,000. B's basis in this portion of Property B is $10,000 under section 732(b). As a result, B has a built-in gain of $20,000 in this portion of Property B immediately after the distribution ($30,000 fair market value less $10,000 adjusted tax basis). This built-in gain is greater than the $10,000 of built-in gain in Property B at the time of contribution to the partnership. B therefore does not recognize any gain on the distribution of a portion of Property B to A under this section.

(d) *Special rules*—(1) *Nonrecognition transactions.* Property received by the partnership in exchange for section 704(c) property in a nonrecognition transaction is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the property received is treated as section 704(c) property under § 1.704–3(a)(8). See § 1.737–2(d)(3) for a similar rule in the context of section 737.

(2) *Transfers of a partnership interest.* The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See § 1.704–3(a)(7).

(3) *Distributions of like-kind property.* If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property

(within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the non-contributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section. See §1.707–3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

(4) *Example.* The following example illustrates the rules of this paragraph (d). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Distribution of like-kind property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $20,000 and an adjusted tax basis of $10,000. B and C each contribute $20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like-kind to Property A with a fair market value and adjusted tax basis of $8,000. The fair market value of Property X subsequently increases to $10,000.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution. At the same time, Property X is distributed to A in a current distribution. The distribution of Property X does not result in the contribution of Property A being properly characterized as a disguised sale to the partnership under §1.707–3. A's basis in Property X is $8,000 under section 732(a)(1). A therefore has $2,000 of built-in gain in Property X ($10,000 fair market value less $8,000 adjusted tax basis).

(iii) A would generally recognize $10,000 of gain under section 704(c)(1)(B) on the distribution of Property A, the difference between the fair market value ($20,000) of the property and its adjusted tax basis ($10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only $8,000 of gain on the distribution of Property A to B under section 704(c)(1)(B) and this section.

(e) *Basis adjustments*—(1) *Contributing partner's basis in the partnership interest.* The basis of the contributing partner's interest in the partnership is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B) and this section. This increase or decrease is taken into account in determining (i) the contributing partner's adjusted tax basis under section 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property, other than like-kind property described in paragraph (d)(3) of this section (pertaining to the special rule for distributions of like-kind property), and (ii) the amount of the gain recognized by the contributing partner under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of the contributed property. For a determination of basis in a distribution subject to section 737, see §1.737–3(a).

(2) *Partnership's basis in partnership property.* The partnership's adjusted tax basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain or loss recognized by the contributing partner under section 704(c)(1)(B) and this section. Any increase or decrease in basis

is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under section 732. For a determination of basis in a distribution subject to section 737, see §1.737–3(b).

(3) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (e)(2) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including the distributed section 704(c) property) under section 734(b) pursuant to a section 754 election must be made after (and must take into account) the adjustments to basis made under paragraph (e)(2) of this section. See §1.737–3(c)(4) for a similar rule in the context of section 737.

(4) *Example.* The following example illustrates the rules of this paragraph (e). Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example. Basis adjustment. On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. B and C each contribute $20,000 cash.

(ii) On December 31, 1998, Property A is distributed to B in a current distribution.

(iii) Under paragraph (a) of this section, A recognizes $6,000 of gain on the distribution of Property A because that is the amount of gain that would have been allocated to A under section 704(c)(1)(A) and §1.704–3 on a sale of Property A for its fair market value at the time of the distribution (fair market value of Property A ($10,000) less its adjusted tax basis at the time of distribution ($4,000)). The adjusted tax basis of A's partnership interest is increased from $14,000 to $20,000 to reflect this gain. The partnership's adjusted tax basis in Property A is increased from $4,000 to $10,000 immediately prior to its distribution to B. B's adjusted tax basis in Property A is therefore $10,000 under section 732(a)(1).

(f) *Anti-abuse rule*—(1) *In general.* The rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 704(c)(1)(B) and this section. Whether a tax result is inconsistent with the purpose of section 704(c)(1)(B) and this section must be determined based on all the facts and circumstances. See §1.737–4 for an anti-abuse rule and examples in the context of section 737.

(2) *Examples.* The following examples illustrate the anti-abuse rule of this paragraph (f). The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 704(c)(1)(B), and all partners are unrelated.

Example 1. Distribution in substance made within five-year period; results inconsistent with the purpose of section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B and C each contributes $10,000 cash.

(ii) On December 31, 1998, the partners desire to distribute Property A to B in complete liquidation of B's interest in the partnership. If Property A were distributed at that time, however, A would recognize $9,000 of gain under section 704(c)(1)(B), the difference between the $10,000 fair market value and the $1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than five years before December 31, 1998. On becoming aware of this potential gain recognition, and with a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, 1998, and take any other steps necessary to provide that substantially all of the economic risks and benefits of Property A are borne by B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C. The partnership holds Property A until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

(iii) The actual distribution of Property A occurred more than five years after the contribution of the property to the partnership. The steps taken by the partnership on December 31, 1998, however, are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance distributed to another partner within five years of its contribution to the partnership. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 1* that have the effect of a distribution of property within five years of the date of its contribution to the partnership would effectively undermine the purpose of section 704(c)(1)(B) and this section. As a result, the steps taken by the partnership on December 31, 1998, are treated as causing a distribution of Property A to B for purposes of section 704(c)(1)(B) on that date, and A recognizes gain of $9,000 under section 704(c)(1)(B) and this section at that time.

(iv) Alternatively, if on becoming aware of the potential gain recognition to A on a distribution of Property A on December 31, 1998, the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property A to B on January 5, 2000, would not have been inconsistent with the purpose of section 704(c)(1)(B) and this section. In that situation, Property A would not have been distributed until after the expiration of the five-year period specified in section 704(c)(1)(B) and this section. Deferring the distribution of Property A until the end of the five-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) and this section is not inconsistent with the purpose of section 704(c)(1)(B). Therefore, A would not have recognized gain on the distribution of Property A in that case.

Example 2. Suspension of five-year period in manner consistent with the purpose of section 704(c)(1)(B). (i) A, B, and C form partnership ABC on January 1, 1995, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes $10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquiror of Property A.

(ii) On December 31, 1997, D is admitted as a partner to the partnership in exchange for $10,000 cash.

(iii) On January 5, 2000, Property A is distributed to D in complete liquidation of D's interest in the partnership.

(iv) The distribution of Property A to D occurred more than five years after the contribution of the property to the partnership. On these facts, however, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquiror of Property A, and treating the five-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). Prior to the admission of D as a partner, the pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a sufficient pooling of assets for purposes of running the five-year period with respect to the distribution of Property A to D. Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as those in this *Example 2* would have the effect of substantially nullifying the five-year requirement of section 704(c)(1)(B) and this section and elevating the form of the transaction over its substance. As a result, with respect to the distribution of Property A to D, the five-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997. Therefore, the distribution of Property A occurred before the end of the five-year period of section 704(c)(1)(B), and A recognizes gain of $9,000 under section 704(c)(1)(B) on the distribution.

(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66730, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25500, May 9, 1997]

§ 1.705–1 Determination of basis of partner's interest.

(a) *General rule.* (1) Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704(d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's ''capital'', ''equity'', or similar account. For example, A contributes property with an adjusted basis to him of $400 (and a value of $1,000) to a partnership. B contributes $1,000 cash. While under their agreement each may have a ''capital account'' in the partnership of $1,000, the adjusted basis of A's interest is only $400 and B's interest $1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Taxable income of the partnership as determined under section 703(a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property, unless the property is an oil or gas property the basis of which has been allocated to partners under section 613A(c)(7)(D).

(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) The basis shall be decreased (but not below zero) by the amount of the partner's deduction for depletion allowable under section 611 for any partnership oil and gas property to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the partner under section 613A(c)(7)(D).

(5) The basis shall be adjusted (but not below zero) to reflect any gain or loss to the partner resulting from a disposition by the partnership of a domestic oil or gas property after December 31, 1974.

(6) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and § 1.752–1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of subchapter K, chapter 1 of the Code, or any of the sections thereof, the partner's share of partnership liabilities on that date shall be included.

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock or any position in stock to which section 1032 applies of a corporation that holds a direct or indirect interest in the partnership, see § 1.705–2.

(b) *Alternative rule.* In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example 1. The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of $1,500 and has earned and retained an additional $1,500. The total adjusted basis of partnership property is thus $3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or $1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example 2. Assume that partner A in example 1 of this paragraph sells his partnership interest to D for $1,250 at a time when the partnership property with an adjusted basis of $1,500 had appreciated in value to $3,000, and when the partnership also had $750 in cash. The total adjusted basis of all partnership property is $2,250 and the value of such property is $3,750. D's basis for his partnership interest is his cost, $1,250. However, his one-third share of the adjusted basis of partnership property is only $750. Therefore, for the purposes of the alternative rule, D has an adjustment of $500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional $1,500, its property will have an adjusted basis of $3,750. D's adjusted basis for his interest under the alternative rule is $1,750, determined by adding $500, his basis adjustment to $1,250 (his one-third share of the $3,750 adjusted basis of partnership property). If the partnership distributes $250 to each partner in a current distribution, D's adjusted basis for his interest will be $1,500 ($1,000, his one-third share of the remaining basis of partnership property, $3,000, plus his basis adjustment of $500).

Example 3. Assume that BCD partnership in example 2 of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Receivables	4,000	4,000
Depreciable property	5,000	5,000
Land held for investment	18,000	30,000
Total	30,000	42,000

Liabilities and capital	Per books
Liabilities	$6,000
Capital accounts:	
B	4,500
C	4,500
D	15,000
Total	30,000

The $15,000 representing the amount of D's capital account does not reflect the $500 basis adjustment arising from D's purchase of his interest. See example 2 of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale	$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)	2,000
D's basis adjustment from example 2	500
Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule	17,500

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8437, 57 FR 43903, Sept. 23, 1992; T.D. 8986, 67 FR 15114, Mar. 29, 2002; T.D. 9049, 68 FR 12816, Mar. 18, 2003]

§ 1.705–2 Basis adjustments coordinating sections 705 and 1032.

(a) *Purpose.* This section coordinates the application of sections 705 and 1032 and is intended to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. The rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis). However, in situations where a section 754 election was not in effect for the year in which a partner acquired its interest, the partner's inside basis and outside basis may not be equal. Similarly, in situations where a section 754 election was not in effect for the year in which a partnership distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted, the remaining partners' inside basis and outside basis may not be equal. In these situations, gain or loss allocated to the partner upon disposition of the partnership assets that is attributable to the difference between the adjusted basis of the partnership assets absent the section 754 election and the adjusted basis of the partnership assets had a section 754 election been in effect generally will result in an adjustment to the basis of the partner's interest in the partnership under section 705(a). Such gain (or loss) therefore generally will be offset by a corresponding decrease in the gain or increase in the loss (or increase in the gain or decrease in the loss) upon the subsequent disposition by the partner of its interest in the partnership. Where such a difference exists with respect to stock of a corporate partner that is held by the partnership, gain or loss from the disposition of corporate partner stock attributable to the difference is not recognized by the corporate partner under section 1032. To adjust the basis of the corporate partner's interest in the partnership for this unrecognized gain or loss would not be appropriate because it would create an opportunity for the recognition of taxable gain or loss on a subsequent disposition of the partnership interest where no economic gain or loss has been incurred by the corporate partner and no corresponding taxable gain or loss had previously been allocated to the corporate partner by the partnership.

(b) *Single partnership*—(1) *Required adjustments relating to acquisitions of partnership interest.* (i) This paragraph (b)(1) applies in situations where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the corporation acquired the interest, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(1) are illustrated by the following example:

Example. (i) A, B, and C form equal partnership PRS. Each partner contributes $30,000 in exchange for its partnership interest. PRS has no liabilities. PRS purchases stock in corporation X for $30,000, which appreciates in value to $120,000. PRS also purchases inventory for $60,000, which appreciates in value to $150,000. A sells its interest in PRS to corporation X for $90,000 in a year for which an election under section 754 is not in effect. PRS later sells the X stock for $150,000. PRS realizes a gain of $120,000 on the sale of the X stock. X's share of the gain is $40,000. Under section 1032, X does not recognize its share of the gain.

(ii) Normally, X would be entitled to a $40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the X stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which X acquired its interest in PRS, X would have been entitled to a basis adjustment under section 743(b) of $60,000 (the excess of X's basis for the transferred partnership interest over X's share of the adjusted basis to PRS of PRS's property). See §1.743–1(b). Under §1.755–1(b), the basis adjustment under section 743(b) would have been allocated $30,000 to the X stock (the amount of the gain that would have been allocated to X from the hypothetical sale of the stock), and $30,000 to the inventory (the amount of the gain that would have been allocated to X from the hypothetical sale of the inventory).

(iii) If a section 754 election had been in effect for the year in which X acquired its interest in PRS, the amount of gain that X would have recognized upon PRS's disposition of X stock (absent the application of section 1032) would be $10,000 (X's share of PRS's gain from the stock sale, $40,000, minus the amount of X's basis adjustment under section 743(b), $30,000). See §1.743–1(j). Accordingly, the increase in the basis of X's interest in PRS is $10,000.

(2) *Required adjustments relating to distributions.* (i) This paragraph (b)(2) applies in situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the partnership made the distribution, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(2) are illustrated by the following example:

Example. (i) A, B, and corporation C form partnership PRS. A and B each contribute $10,000 and C contributes $20,000 in exchange for a partnership interest. PRS has no liabilities. PRS purchases stock in corporation C for $10,000, which appreciates in value to $70,000. PRS distributes $25,000 to A in complete liquidation of A's interest in PRS in a year for which an election under section 754 is not in effect. PRS later sells the C stock for $70,000. PRS realizes a gain of $60,000 on the sale of the C stock. C's share of the gain is $40,000. Under section 1032, C does not recognize its share of the gain.

(ii) Normally, C would be entitled to a $40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the C stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which PRS made the distribution to A, PRS would have been entitled to adjust the basis of partnership property under section 734(b)(1)(A) by $15,000 (the amount of gain recognized by A with respect to the distribution to A under section 731(a)(1)). See §1.734–1(b). Under §1.755–1(c)(1)(ii), the basis adjustment under section 734(b) would have been allocated to the C stock, increasing its basis to $25,000 (where there is a distribution resulting in an adjustment under section 734(b)(1)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property).

(iii) If a section 754 election had been in effect for the year in which PRS made the distribution to A, the amount of gain that PRS would have recognized upon PRS's disposition of C stock would be $45,000 ($70,000 minus $25,000 basis in the C stock), and the amount of gain C would have recognized upon PRS's disposition of the C stock (absent the application of section 1032) would be $30,000 (C's share of PRS's gain of $45,000 from the stock sale). Accordingly, upon PRS's sale of the C stock, the increase in the basis of C's interest in PRS is $30,000.

(c) *Tiered partnerships and other arrangements*—(1) *Required adjustments.* The purpose of these regulations as set forth in paragraph (a) of this section cannot be avoided through the use of tiered partnerships or other arrangements. For example, if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section. Similarly, if a corporation owns an indirect interest in its own stock through a chain of two or more partnerships, and a partnership in the chain distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under section 754 in effect, then upon any subsequent sale or exchange of the stock, the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

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

Example 1. Acquisition of upper-tier partnership interest by corporation. (i) A, B, and C form a partnership (UTP), with each partner contributing $25,000. UTP and D form a partnership (LTP). UTP contributes $75,000 in exchange for its interest in LTP, and D contributes $25,000 in exchange for D's interest in LTP. Neither UTP nor LTP has any liabilities. LTP purchases stock in corporation E for $100,000, which appreciates in value to $1,000,000. C sells its interest in UTP to corporation E for $250,000 in a year for which an election under section 754 is not in effect for UTP or LTP. LTP later sells the E stock for $2,000,000. LTP realizes a $1,900,000 gain on the sale of the E stock. UTP's share of the gain is $1,425,000, and E's share of the gain is $475,000. Under section 1032, E does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the E stock (including E's share) were to increase the basis of UTP's interest in LTP, UTP's basis in such interest would be $1,500,000 ($75,000 + $1,425,000). The fair market value of UTP's interest in LTP is $1,500,000. Because UTP did not have a section 754 election in effect for the taxable year in which E acquired its interest in UTP, UTP's basis in the LTP interest does not reflect the purchase price paid by E for its interest. Increasing the basis of UTP's interest in LTP by the full amount of the gain that would be recognized (in the absence of section 1032) on the sale of the E stock preserves the conformity between UTP's inside basis and outside basis with respect to LTP (i.e., UTP's share of LTP's cash is equal to $1,500,000, and UTP's basis in the LTP interest is $1,500,000) and appropriately would cause UTP to recognize no gain or loss on the sale of UTP's interest in LTP immediately after the sale of the E stock. Accordingly, increasing the basis of UTP's interest in LTP by the entire amount of gain allocated to UTP (including E's share) from LTP's sale of the E stock is consistent with the purpose of this section. The $1,425,000 of gain allocated by LTP to UTP will increase the adjusted basis of UTP's interest in LTP under section 705(a)(1). The basis of UTP's interest in LTP immediately after the sale of the E stock is $1,500,000.

(iii) With respect to the basis of E's interest in UTP, if E's share of the gain allocated to UTP and then to E were to increase the basis of E's interest in UTP, E's basis in such interest would be $725,000 ($250,000 + $475,000) and the fair market value of such interest would be $500,000, so that E would recognize a loss of $225,000 if E sold its interest in UTP immediately after LTP's disposition of the E stock. It would be inappropriate for E to recognize a taxable loss of $225,000 upon a disposition of its interest in UTP because E would not incur an economic loss in the transaction, and E did not recognize a taxable gain upon LTP's disposition of the E stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing E's basis in its UTP interest by the entire amount of gain allocated to E from the sale of the E stock is not consistent with the purpose of this section. (Conversely, because A and B were allocated taxable gain on the disposition of the E stock, it would be appropriate to increase A's and B's bases in their respective interests in UTP by the full amount of the gain allocated to them.)

(iv) The appropriate basis adjustment for E's interest in UTP upon the disposition of the E stock by LTP can be determined as the amount of gain that E would have recognized (in the absence of section 1032) upon the sale by LTP of the E stock if both UTP and LTP had made section 754 elections for the taxable year in which E acquired the interest in UTP. If section 754 elections had been in effect for UTP and LTP for the year in which E acquired E's interest in UTP, the following would occur. E would be entitled to a $225,000 positive basis adjustment under section 743(b) with respect to the property of UTP. The entire basis adjustment would be allocated to UTP's only asset, its interest in LTP. In addition, the sale of C's interest in UTP would be treated as a deemed sale of E's share of UTP's interest in LTP for purposes of sections 754 and 743. The deemed selling price of E's share of UTP's interest in LTP would be $250,000 (E's share of UTP's adjusted basis in LTP, $25,000, plus E's basis adjustment under section 743(b) with respect to the assets of UTP, $225,000). The deemed sale of E's share of UTP's interest in LTP would trigger a basis adjustment under section 743(b) of $225,000 with respect to the assets of LTP (the excess of E's share of UTP's adjusted basis in LTP, including E's basis adjustment ($225,000), $250,000, over E's share of the adjusted basis of LTP's property, $25,000). This $225,000 adjustment by LTP would be allocated to LTP's only asset, the E stock, and would be segregated and allocated solely to E. The amount of LTP's gain from the sale of the E stock (before considering section 743(b)) would be $1,900,000. E's share of this gain, $475,000, would be offset in part by the $225,000 basis adjustment under section 743(b), so that E would recognize gain equal to $250,000 in the absence of section 1032.

(v) If the basis of E's interest in UTP were increased by $250,000, the total basis of E's interest would equal $500,000. This would conform to E's share of UTP's basis in the LTP interest ($1,500,000×1/3=$500,000) as well as E's indirect share of the cash held by LTP ((1/3×3/4)×$2,000,000=$500,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by E on a subsequent disposition of E's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the $475,000 gain allocated to E, only $250,000 will apply to increase the adjusted basis of E in UTP under section 705(a)(1). E's adjusted basis in its UTP interest following the sale of the E stock is $500,000.

Example 2. Acquisition of lower-tier partnership interest by upper-tier partnership. (i) A, corporation B, and C form an equal partnership (UTP), with each partner contributing $100,000. D, E, and F also form an equal partnership (LTP), with each partner contributing $30,000. LTP purchases stock in corporation B for $90,000, which appreciates in value to $900,000. LTP has no liabilities. UTP purchases D's interest in LTP for $300,000. LTP does not have an election under section 754 in effect for the taxable year of UTP's purchase. LTP later sells the B stock for $900,000. UTP's share of the gain is $270,000, and B's share of that gain is $90,000. Under section 1032, B does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the B stock (including B's share) were to increase the basis of UTP's interest in LTP, UTP's basis in the LTP interest would be $570,000 ($300,000 + $270,000), and the fair market value of such interest would be $300,000, so that B would be allocated a loss of $90,000 (($570,000 − $300,000)×1/3) if UTP sold its interest in LTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of $90,000 upon a disposition of UTP's interest in LTP. B would not incur an economic loss in the transaction, and B was not allocated a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of UTP's interest in LTP. Accordingly, increasing UTP's basis in its LTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because E and F were allocated taxable gain on the disposition of the B stock, it would be appropriate to increase E's and F's bases in their respective interests in LTP by the full amount of such gain.)

(iii) The appropriate basis adjustment for UTP's interest in LTP upon the disposition of the B stock by LTP can be determined as the amount of gain that UTP would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that subsequently is allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a $90,000 positive basis adjustment under section 743(b), allocable to B, in the property of LTP. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be $810,000. UTP's share of this gain, $270,000, would be offset, in part, by the basis adjustment under section 743(b), so that UTP would recognize gain equal to $180,000.

(iv) If the basis of UTP's interest in LTP were increased by $180,000, the total basis of UTP's partnership interest would equal $480,000. This would conform to the sum of UTP's share of the cash held by LTP ((1/3×$900,000=$300,000) and the taxable gain recognized by A and C on the disposition of the B stock that appropriately may be offset on the disposition of their interests in UTP ($90,000+$90,000=$180,000). Such a basis adjustment does not inappropriately create the opportunity for the allocation of a loss to B on a subsequent disposition of UTP's interest in LTP and is consistent with the purpose of this section. Accordingly, of the $270,000 gain allocated to UTP, only $180,000 will apply to increase the adjusted basis of UTP in LTP under section 705(a)(1). Such $180,000 basis increase must be segregated and allocated $90,000 each to solely A and C. UTP's adjusted basis in its LTP interest following the sale of the B stock is $480,000.

(v) With respect to B's interest in UTP, if B's share of the gain allocated to UTP and then to B were to increase the basis of B's interest in UTP, B would have a UTP partnership interest with an adjusted basis of $190,000 ($100,000 + $90,000) and a value of $100,000, so that B would recognize a loss of $90,000 if B sold its interest in UTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of $90,000 upon a disposition of its interest in UTP because B would not incur an economic loss in the transaction, and B did not recognize a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing B's basis in its UTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because A and C were allocated taxable gain on the disposition of the B stock that is a result of LTP not having a section 754 election in effect, it would be appropriate for A and C to recognize an offsetting taxable loss on the disposition of A's and C's interests in UTP. Accordingly, it would be appropriate to increase A's and C's bases in their respective interests in UTP by the amount of gain recognized by A and C.)

(vi) The appropriate basis adjustment for B's interest in UTP upon the disposition of the B stock by LTP can be determined as the amount of gain that B would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that is subsequently allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a basis adjustment under section 743(b) in the property of LTP of $90,000 with respect to B. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be $810,000. UTP's share of this gain, $270,000, would be offset, in part, by the $90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to $180,000. The $90,000 basis adjustment would completely offset the gain that otherwise would be allocated to B.

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal $100,000. This would conform to B's share of UTP's basis in the LTP interest (($480,000 − $180,000 (i.e., A's and C's share of the basis that should offset taxable gain recognized as a result of LTP's failure to have a section 754 election))×1/3=$100,000) as well as B's indirect share of the cash held by LTP ((1/3×1/3)×$900,000=$100,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the $90,000 gain allocated to B, none will apply to increase the adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is $100,000.

(viii) Immediately after LTP's disposition of the B stock, UTP sells its interest in LTP for $300,000. UTP's adjusted basis in its LTP interest is $480,000, $180,000 of which must be allocated $90,000 each to A and C. Accordingly, upon UTP's sale of its interest in LTP, UTP realizes $180,000 of loss, and A and C in turn each realize $90,000 of loss.

(d) *Positions in Stock.* For purposes of this section, stock includes any position in stock to which section 1032 applies.

(e) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999, except that paragraph (d) of this section is applicable with respect to sales or exchanges of stock occurring on or after March 29, 2002, and the fourth sentence of paragraph (a), paragraph (b)(2), and the third sentence of paragraph (c)(1) of this section are applicable with respect to sales or exchanges of stock occurring on or after March 18, 2003.

[T.D. 8986, 67 FR 15114, Mar. 29, 2002, as amended by T.D. 9049, 68 FR 12816, Mar. 18, 2003]

§ 1.706–1 Taxable years of partner and partnership.

(a) *Year in which partnership income is includible.* (1) In computing taxable income for a taxable year, a partner is required to include the partner's distributive share of partnership items set forth in section 702 and the regulations thereunder for any partnership taxable year ending within or with the partner's taxable year. A partner must also include in taxable income for a taxable year guaranteed payments under section 707(c) that are deductible by the partnership under its method of accounting in the partnership taxable year ending within or with the partner's taxable year.

(2) The rules of this paragraph (a)(1) may be illustrated by the following example:

Example. Partner A reports income using a calendar year, while the partnership of which A is a member reports its income using a fiscal year ending May 31. The partnership reports its income and deductions under the cash method of accounting. During the partnership taxable year ending May 31, 2002, the partnership makes guaranteed payments of $120,000 to A for services and for the use of capital. Of this amount, $70,000 was paid to A between June 1 and December 31, 2001, and the remaining $50,000 was paid to A between January 1 and May 31, 2002. The entire $120,000 paid to A is includible in A's taxable income for the calendar year 2002 (together with A's distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 2002).

(3) If a partner receives distributions under section 731 or sells or exchanges all or part of a partnership interest, any gain or loss arising therefrom does not constitute partnership income.

(b) *Taxable year*—(1) *Partnership treated as a taxpayer.* The taxable year of a partnership must be determined as though the partnership were a taxpayer.

(2) *Partnership's taxable year*—(i) *Required taxable year.* Except as provided in paragraph (b)(2)(ii) of this section, the taxable year of a partnership must be—

(A) The majority interest taxable year, as defined in section 706(b)(4);

(B) If there is no majority interest taxable year, the taxable year of all of the principal partners of the partnership, as defined in 706(b)(3) (the principal partners' taxable year); or

(C) If there is no majority interest taxable year or principal partners' taxable year, the taxable year that produces the least aggregate deferral of income as determined under paragraph (b)(3) of this section.

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

(3) *Least aggregate deferral*—(i) *Taxable year that results in the least aggregate deferral of income.* The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that produces the lowest sum when compared to the other partner's taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable year. The determination of the taxable year that results in the least aggregate deferral of income generally must be made as of the beginning of the partnership's current taxable year. The director, however, may determine that the first day of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.

(ii) *Determination of the taxable year of a partner or partnership that uses a 52–53-week taxable year.* For purposes of the calculation described in paragraph (b)(3)(i) of this section, the taxable year of a partner or partnership that uses a 52–53-week taxable year must be the same year determined under the rules of section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(iii) *Special de minimis rule.* If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current taxable year, the partnership's current taxable year will be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year.

(iv) *Examples.* The principles of this section may be illustrated by the following examples:

Example 1. Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent interest in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest× deferral
Partner A	6/30	.5	0	0
Partner B	7/31	.5	1	.5
Aggregate deferral				.5

Test 7/31	Year end	Interest in partnership profits	Months of deferral for 7/31 year end	Interest× deferral
Partner A	6/30	.5	11	5.5
Partner B	7/31	.5	0	0
Aggregate deferral				5.5

Example 2. The facts are the same as in *Example 1* except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 12/31	Year end	Interest in partnership profits	Months of deferral for 12/31 year end	Interest× deferral
Partner A	12/31	.5	0	0
Partner B	11/30	.5	11	5.5
Aggregate deferral				5.5

Test 11/30	Year end	Interest in partnership profits	Months of deferral for 11/30 year end	Interest× deferral
Partner A	12/31	.5	1	.5
Partner B	11/30	.5	0	0
Aggregate deferral				.5

Example 3. The facts are the same as in *Example 2* except that B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year ends June 30, it must retain its current taxable year. The determination is made as follows:

Test 12/31	Year end	Interest in partnership profits	Months of deferral for 12/31 year end	Interest× deferral
Partner A	12/31	.5	0	0
Partner B	6/30	.5	6	3.0
Aggregate deferral				3.0

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest× deferral
Partner A	12/31	.5	6	3.0
Partner B	6/30	.5	0	0
Aggregate deferral				3.0

Example 4. The facts are the same as in *Example 1* except that on December 31, 1987, partner A sells a 4 percent interest in the partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending June 30. The taxable year beginning July 1, 1987, is unaffected by the sale. However, for the taxable year beginning July 31, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that results in the least aggregate deferral of income to the partners.

Example 5. The facts are the same as in *Example 4* except that Partner D reports income on the fiscal year ending April 30. As in *Example 4,* the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the fiscal year ending April 30. This determination is made as follows:

Test 7/31	Year end	Interest in partnership profits	Months of deferral for 7/31 year end	Interest× deferral
Partner A	6/30	.06	11	.66
Partner B	7/31	.5	0	0
Partner C	6/30	.04	11	.44
Partner D	4/30	.4	9	3.60
Aggregate deferral				4.70

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest× deferral
Partner A	6/30	.06	0	0
Partner B	7/31	.5	1	.5
Partner C	6/30	.04	0	0
Partner D	4/30	.4	10	4.0
Aggregate deferral				4.5

Test 4/30	Year end	Interest in partnership profits	Months of deferral for 4/30 year end	Interest× deferral
Partner A	6/30	.06	2	.12
Partner B	7/31	.5	3	1.50
Partner C	6/30	.04	2	.08
Partner D	4/30	.4	0	0
Aggregate deferral				1.70

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Current taxable year (June 30)	4.5
Less: Taxable year producing the least aggregate deferral (April 30)	1.7
Additional aggregate deferral (greater than .5)	2.8

Example 6. (i) Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under paragraph (b)(3) of this

section to be the fiscal year ending March 31 as follows:

Test 3/31	Year end	Interest in partnership profits	Deferral for 3/31 year end	Interest× deferral
Partner A	3/31	.5	0	0
Partner B	7/31	.5	4	2
Aggregate deferral				2

Test 7/31	Year end	Interest in partnership profits	Deferral for 7/31 year end	Interest× deferral
Partner A	3/31	.5	8	4
Partner B	7/31	.5	0	0
Aggregate deferral				4

(ii) In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (b)(3)(iii) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31	Year end	Interest in partnership profits	Deferral for 3/31 year end	Interest× deferral
Partner A	3/31	.05	0	0
Partner B	7/31	.5	4	2.0
Partner C	4/30	.45	1	.45
Aggregate deferral				2.45

Test 7/31	Year end	Interest in partnership profits	Deferral for 7/31 year end	Interest× deferral
Partner A	3/31	.05	8	.40
Partner B	7/31	.5	0	0
Partner C	4/30	.45	9	4.05
Aggregate deferral				4.45

Test 4/30	Year end	Interest in partnership profits	Deferral for 4/30 year end	Interest× deferral
Partner A	3/31	.05	11	.55
Partner B	7/31	.5	3	1.50
Partner C	4/30	.45	0	0
Aggregate deferral				2.05

§ 1.706–1(B)(3) TEST

Current taxable year (3/31)	2.45
Less: Taxable year producing the least aggregate deferral (4/30)	2.05
Additional aggregate deferral (less than .5)	.40

(4) *Measurement of partner's profits and capital interest*—

(i) *In general.* The rules of this paragraph (b)(4) apply in determining the majority interest taxable year, the principal partners' taxable year, and the least aggregate deferral taxable year.

(ii) *Profits interest*—(A) *In general.* For purposes of section 706(b), a partner's interest in partnership profits is generally the partner's percentage share of partnership profits for the current partnership taxable year. If the partnership does not expect to have net income for the current partnership taxable year, then a partner's interest in partnership profits instead must be the partner's percentage share of partnership net income for the first taxable year in which the partnership expects to have net income.

(B) *Percentage share of partnership net income.* The partner's percentage share of partnership net income for a partnership taxable year is the ratio of: the partner's distributive share of partnership net income for the taxable year, to the partnership's net income for the year. If a partner's percentage share of partnership net income for the taxable year depends on the amount or nature of partnership income for that year (due to, for example, preferred returns or special allocations of specific partnership items), then the partnership must make a reasonable estimate of the amount and nature of its income for the taxable year. This estimate must be based on all facts and circumstances known to the partnership as of the first day of the current partnership taxable year. The partnership must then use this estimate in determining the partners' interests in partnership profits for the taxable year.

(C) *Distributive share.* For purposes of this paragraph (b)(4)(ii), a partner's distributive share of partnership net income is determined by taking into account all rules and regulations affecting that determination, including, without limitation, sections 704(b), (c), and (e), 736, and 743.

(iii) *Capital interest.* Generally, a partner's interest in partnership capital is determined by reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon liquidation of the partnership. If the partnership maintains capital accounts in accordance with §1.704–1(b)(2)(iv), then for purposes of section 706(b), the partnership may assume that a partner's interest in partnership capital is the ratio of the partner's capital account to all partners' capital accounts as of the first day of the partnership taxable year.

(5) *Taxable year of a partnership with tax-exempt partners*—(i) *Certain tax-exempt partners disregarded.* In determining the taxable year (the current year) of a partnership under section 706(b) and the regulations thereunder, a partner that is tax-exempt under section 501(a) shall be disregarded if such partner was not subject to tax, under chapter 1 of the Internal Revenue Code, on any income attributable to its investment in the partnership during the partnership's taxable year immediately preceding the current year. However, if a partner that is tax-exempt under section 501(a) was not a partner during the partnership's immediately preceding taxable year, such partner will be disregarded for the current year if the partnership reasonably believes that the partner will not be subject to tax, under chapter 1 of the Internal Revenue Code, on any income attributable to such partner's investment in the partnership during the current year.

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

Example. Assume that partnership A has historically used the calendar year as its taxable year. In addition, assume that A is owned by 5 partners, 4 calendar year individuals (each owning 10 percent of A's profits and capital) and a tax-exempt organization (owning 60 percent of A's profits and capital). The tax-exempt organization has never had unrelated business taxable income with respect to A and has historically used a June 30 fiscal year. Finally, assume that A desires to retain the calendar year for its taxable year beginning January 1, 2003. Under these facts and but for the special rule in paragraph (b)(5)(i) of this section, A would be required under section 706(b)(1)(B)(i) to change to a year ending June 30, for its taxable year beginning January 1, 2003. However, under the special rule provided in paragraph (b)(5)(i) of this section the partner that is tax-exempt is disregarded, and A must retain the calendar year, under section 706(b)(1)(B)(i), for its taxable year beginning January 1.

(iii) *Effective date.* The provisions of this paragraph (b)(5) are applicable for taxable years beginning on or after

July 23, 2002. For taxable years beginning before July 23, 2002, see §1.706–3T as contained in 26 CFR part 1 revised April 1, 2002.

(6) *Certain foreign partners disregarded*—(i) *Interests of disregarded foreign partners not taken into account.* In determining the taxable year (the current taxable year) of a partnership under section 706(b) and the regulations thereunder, any interest held by a disregarded foreign partner is not taken into account. A foreign partner is a disregarded foreign partner unless such partner is allocated any gross income of the partnership that was effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States during the partnership's taxable year immediately preceding the current taxable year (or, if such partner was not a partner during the partnership's immediately preceding taxable year, the partnership reasonably believes that the partner will be allocated any such income during the current taxable year) and taxation of that income is not otherwise precluded under any U.S. income tax treaty.

(ii) *Definition of foreign partner.* For purposes of this paragraph (b)(6), a foreign partner is any partner that is not a U.S. person (as defined in section 7701(a)(30)), except that a partner that is a controlled foreign corporation (as defined in section 957(a)) or a foreign personal holding company (as defined in section 552) shall not be treated as a foreign partner.

(iii) *Minority interest rule.* If each partner that is not a disregarded foreign partner under paragraph (b)(6)(i) of this section (regarded partner) holds less than a 10-percent interest, and the regarded partners, in the aggregate, hold less than a 20-percent interest in the capital or profits of the partnership, then paragraph (b)(6)(i) of this section does not apply. In determining ownership in a partnership for purposes of this paragraph (b)(6)(iii), each regarded partner is treated as owning any interest in the partnership owned by a related partner. For this purpose, partners are treated as related if they are related within the meaning of sections 267(b) or 707(b) (using the language ''10 percent'' instead of ''50 percent'' each place it appears). However, for purposes of determining if partners hold less than a 20-percent interest in the aggregate, the same interests will not be considered as being owned by more than one regarded partner.

(iv) *Example.* The provisions of paragraph (b)(6) of this section may be illustrated by the following example:

Example. Partnership B is owned by two partners, F, a foreign corporation that owns a 95-percent interest in the capital and profits of partnership B, and D, a domestic corporation that owns the remaining 5-percent interest in the capital and profits of partnership B. Partnership B is not engaged in the conduct of a trade or business within the United States, and, accordingly, partnership B does not earn any income that is effectively connected with a U.S. trade or business. F uses a March 31 fiscal year, and causes partnership B to maintain its books and records on a March 31 fiscal year as well. D is a calendar year taxpayer. Under paragraph (b)(6)(i) of this section, F would be disregarded and partnership B's taxable year would be determined by reference to D. However, because D owns less than a 10-percent interest in the capital and profits of partnership B, the minority interest rule of paragraph (b)(6)(iii) of this section applies, and partnership B must adopt the March 31 fiscal year for Federal tax purposes.

(v) *Effective date*—(A) *Generally*. The provisions of this paragraph (b)(6) are applicable for the first taxable year of a partnership other than an existing partnership that begins on or after July 23, 2002. For this purpose, an existing partnership is a partnership that was formed prior to September 23, 2002.

(B) *Voluntary change in taxable year.* An existing partnership may change its taxable year to a year determined in accordance with this section. An existing partnership that makes such a change will cease to be exempted from the requirements of paragraph (b)(6) of this section.

(C) *Subsequent sale or exchange of interests.* If an existing partnership terminates under section 708(b)(1)(B), the resulting partnership is not an existing partnership for purposes of paragraph (b)(6)(v)(A) of this section.

(D) *Transition rule.* If, in the first taxable year beginning on or after July 23, 2002, an existing partnership voluntarily changes its taxable year to a year determined in accordance with this paragraph (b)(6), then the partners of that partnership may apply the provisions of §1.702–3T to take into account all items of income, gain, loss, deduction, and credit attributable to the partnership year of change ratably over a four-year period.

(7) *Adoption of taxable year.* A newly-formed partnership may adopt, in accordance with §1.441–1(c), its required taxable year, a taxable year elected under section 444, or a 52–53-week taxable year ending with reference to its required taxable year or a taxable year elected under section 444 without securing the approval of the Commissioner. If a newly-formed partnership wants to adopt any other taxable year, it must establish a business purpose and secure the approval of the Commissioner under section 442.

(8) *Change in taxable year*—(i) *Partnerships*-(A) *Approval required.* An existing partnership may change its taxable year only by securing the approval of the Commissioner under section 442 or making an election under section 444. However, a partnership may obtain automatic approval for certain changes, including a change to its required taxable year, pursuant to administrative procedures published by the Commissioner.

(B) *Short period tax return.* A partnership that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the partnership taxable income.

(C) *Change in required taxable year.* If a partnership is required to change to its majority interest taxable year, then no further change in the partnership's required taxable year is required for either of the two years following the year of the change. This limitation against a second change within a three-year period applies only if the first change was to the majority interest taxable year and does not apply following a change in the partnership's taxable year to the principal partners' taxable year or the least aggregate deferral taxable year.

(ii) *Partners.* Except as otherwise provided in the Internal Revenue Code or the regulations thereunder (e.g., section 859 regarding real estate investment trusts or §1.442–2(c) regarding a subsidiary changing to its consolidated parent's taxable year), a partner may not change its taxable year without securing the approval of the Commissioner under section 442. However, certain partners may be eligible to obtain automatic approval to change their taxable years pursuant to the regulations or administrative procedures published by the Commissioner. A partner that changes its taxable year must make its return for a short period in accordance with section 443.

(9) *Retention of taxable year.* In certain cases, a partnership will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a change in ownership, unless the partnership previously obtained approval for its current taxable year or, if appropriate, makes an election under section 444.

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

(11) *Effect of partner elections under section 444—(i) Election taken into account.* For purposes of section 706(b)(1)(B), any section 444 election by a partner in a partnership shall be taken into account in determining the taxable year of the partnership. See §1.7519–1T(d), *Example (4).*

(ii) *Effective date.* The provisions of this paragraph (b)(11) are applicable for taxable years beginning on or after July 23, 2002. For taxable years beginning before July 23, 2002, see §1.706–3T as contained in 26 CFR part 1 revised April 1, 2002.

(c) *Closing of partnership year*—(1) *General rule.* Section 706(c) and this paragraph provide rules governing the closing of partnership years. The closing of a partnership taxable year or a termination of a partnership for Federal income tax purposes is not necessarily governed by the ''dissolution'', ''liquidation'', etc., of a partnership under State or local law. The taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's entire interest in the partnership (as defined in section 761(d)), or the sale or exchange of a partner's interest in the partnership, except in the case of a termination of a partnership and except as provided in subparagraph (2) of this paragraph. In the case of termination, the partnership taxable year closes for all partners as of the date of termination. See section 708(b) and paragraph (b) of § 1.708–1.

(2) *Partner who retires or sells interest in partnership*—(i) *Disposition of entire interest.* A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) *Inclusions in taxable income.* In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following example:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of $5,000 on that date; that his pro rata share of partnership income up to June 30 is $15,000; and that he sells his interest for $20,000. Under the provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. The $15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to $20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.

(3) *Partner who dies.* (i) When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year. The partnership taxable year shall continue both for the remaining partners and the decedent partner. Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708(b)(1)(A). See also paragraph (b)(1)(i)(*b*) of § 1.708–1 for the continuation of a 2-member partnership under certain circumstances after the death of a partner. However, if the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest shall close on the

date of such sale or exchange, or the date of completion of the liquidation.

(ii) The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner (i. e., the year ending with the date of his death). The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributives share thereof is includible in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also paragraph (a)(1)(ii) of § 1.736–1. Where the estate or other successor in interest receives distributions, any gain or loss on such distributions is includible in its gross income for its taxable year in which the distribution is made.

(iii) If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter. Thus, where a partner designates his widow as the successor in interest, her distributive share of income for the taxable year of the partnership ending within or with her taxable year may be included in a joint return in accordance with the provisions of sections 2 and 6013(a) (2) and (3).

(iv) If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death. See section 706(c)(2)(A)(i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.

(v) To the extent that any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner is attributable to the decedent for the period ending with the date of his death, such part of the distributive share is income in respect of the decedent under section 691. See section 691 and the regulations thereunder.

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

Example 1. B has a taxable year ending December 31 and is a member of partnership ABC, the taxable year of which ends on June 30. B dies on October 31, 1955. His estate (which as a new taxpayer may, under section 441 and the regulations thereunder, adopt any taxable year) adopts a taxable year ending October 31. The return of the decedent for the period January 1 to October 31, 1955, will include only his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955. The distributive share of taxable income of the partnership for its taxable year ending June 30, 1956, arising from the interest of the decedent, will be includible in the return of the estate for its taxable year ending October 31, 1956. That part of the distributive share attributable to the decedent for the period ending with the date of his death (July 1 through October 31, 1955) is income in respect of a decedent under section 691.

Example 2. Assume the same facts as in example 1 of this subdivision, except that, prior to B's death, B and D had agreed that, upon B's death, D would purchase B's interest for $10,000. When B dies on October 31, 1955, the partnership taxable year beginning July 1, 1955, closes with respect to him. Therefore, the return for B's last taxable year (January 1 to October 31, 1955) will include his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955, plus his distributive share of partnership taxable income for the period July 1 to October 31, 1955. See subdivision (iv) of this subparagraph.

Example 3. H is a member of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 1955. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 1955. Such distribution by the estate is not a sale or exchange of H's partnership interest. No part of the taxable income of the partnership for the taxable year ending December 31, 1955, which is allocable to H, will be included in H's taxable income for his last taxable year (January 1 through March 31, 1955) or in the taxable income of H's estate for the taxable year April 1 through November 30, 1955. The distributive share of partnership taxable income for the full calendar year that is allocable to H will be includible in the taxable income of W for her taxable year ending December 31, 1955, and she may file a joint return under sections 2 and 6013(a)(3). That part of the distributive share attributable to the decedent for the period ending with the date of his death (January 1 through March 31, 1955) is income in respect of a decedent under section 691.

Example 4. M is a member of partnership JKM which operates on a calendar year. M and his wife S file joint returns for calendar years. In accordance with the partnership agreement, M designated S to succeed to his interest in the partnership upon his death. M, who had withdrawn $10,000 from the partnership before his death, dies on October 20, 1955. S's distributive share of income for the taxable year 1955 is $15,000 ($10,000 of which represents the amount withdrawn by M). S shall include $15,000 in her income, even though M received $10,000 of this amount before his death. S may file a joint return with M for the year 1955 under sections 2 and 6013(a). That part of the $15,000 distributive share attributable to the decedent for the period ending with the date of his death (January 1 through October 20, 1955) is income in respect of a decedent under section 691.

(4) *Disposition of less than entire interest.* If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner's distributive share of items which he is required to include in his taxable income under the provisions of section 702(a) shall be determined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

(5) *Transfer of interest by gift.* The transfer of a partnership interest by gift does not close the partnership taxable year with respect to the donor. However, the income up to the date of gift attributable to the donor's interest shall be allocated to him under section 704(e)(2).

(d) *Effective date.* The rules of this section are applicable for taxable years ending on or after May 17, 2002, except for paragraph (c), which applies for taxable years beginning after December 31, 1953.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7286, 38 FR 26912, Sept. 27, 1973; T.D. 8123, 52 FR 3623, Feb. 5, 1987; T.D. 8996, 67 FR 35020, May 17, 2002; T.D. 9009, 67 FR 48019, July 23, 2002]

§ 1.706–2T Temporary regulations; question and answer under the Tax Reform Act of 1984.

Question 1: For purposes of section 706(d), how is an otherwise deductible amount that is deferred under section 267(a)(2) treated?

Answer 1: In the year the deduction is allowed, the deduction will constitute an allocable cash basis item under section 706(d)(2)(B)(iv).

(Secs. 267(f)(2)(B), 706(d)(2)(B)(iv), 1502, and 7805, Internal Revenue Code of 1954 (98 Stat. 704, 26 U.S.C. 267; 98 Stat. 589, 26 U.S.C. 706; 68A Stat. 367, 26 U.S.C. 1502; 68A Stat. 917, 26 U.S.C. 7805))

[T.D. 7991, 49 FR 47001, Nov. 30, 1984]

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[T.D. 8439, 57 FR 44978, Sept. 30, 1992]

§ 1.707–1 Transactions between partner and partnership.

(a) *Partner not acting in capacity as partner.* A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See paragraph(c)(3) of § 1.731–1.

(b) *Certain sales or exchanges of property with respect to controlled partnerships*—(1) *Losses disallowed.* (i) No deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership, directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership. A loss on a sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interest in each partnership shall not be allowed.

(ii) If a gain is realized upon the subsequent sale or exchange by a transferee of property with respect to which a loss was disallowed under the provisions of subdivision (i) of this subparagraph, section 267(d) (relating to amount of gain where loss previously disallowed) shall apply as though the loss were disallowed under section 267(a)(1).

(2) *Gains treated as ordinary income.* Any gain recognized upon the sale or exchange, directly or indirectly, of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset, as defined in section 1221, shall be ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 80 percent of the capital interest or profits interest in the partnership. This rule also applies where such a transaction is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interest or profits interest in each partnership. The term *property other than a capital asset* includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.

(3) *Ownership of a capital or profits interest.* In determining the extent of the ownership by a partner, as defined in section 761(b), of his capital interest or profits interest in a partnership, the rules for constructive ownership of stock provided in section 267(c) (1), (2), (4), and (5) shall be applied for the purpose of section 707(b) and this paragraph. Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761(b) in order that another partner may be considered the constructive owner of such interest under section 267(c). However, section 707(b)(1)(A) does not apply to a constructive owner of a partnership interest since he is not a partner as defined in section 761(b). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW only for the purpose of further attributing the ownership of such interest to A. See section 267(c) (1) and (5). If A, B, and T are equal partners, then A will be considered as owning more than 50 percent of the capital and profits interest in the partnership, and losses on transactions between him and the partnership will be disallowed by section 707(b)(1)(A). However, a loss sustained by AW on a sale or exchange of property with the partnership would not be disallowed by section 707, but will be disallowed to the extent provided in paragraph (b) of § 1.267(b)–1. See section 267 (a) and (b), and the regulations thereunder.

(c) *Guaranteed payments.* Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of §1.706–1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

Example 2. Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Example 3. Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

Example 4. Assume the same facts as in example 3 of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7891, 48 FR 20049, May 4, 1983]

§ 1.707–2 Disguised payments for services. [Reserved]

§ 1.707–3 Disguised sales of property to partnership; general rules.

(a) *Treatment of transfers as a sale*—(1) *In general.* Except as otherwise provided in this section, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1) of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership.

(2) *Definition and timing of sale.* For purposes of §§1.707–3 through 1.707–5, the use of the term sale (or any variation of that word) to refer to a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner means a sale or exchange of that property, in whole or in part, to the partnership by the partner acting in a capacity other

than as a member of the partnership, rather than a contribution and distribution to which sections 721 and 731, respectively, apply. A transfer that is treated as a sale under paragraph (a)(1) this section is treated as a sale for all purposes of the Internal Revenue Code (*e.g.*, sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership; the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

(3) *Application of disguised sale rules.* If a person purports to transfer property to a partnership in a capacity as a partner, the rules of this section apply for purposes of determining whether the property was transferred in a disguised sale, even if it is determined after the application of the rules of this section that such person is not a partner. If after the application of the rules of this section to a purported transfer of property to a partnership, it is determined that no partnership exists because the property was actually sold, or it is otherwise determined that the contributed property is not owned by the partnership for tax purposes, the transferor of the property is treated as having sold the property to the person (or persons) that acquired ownership of the property for tax purposes.

(4) *Deemed terminations under section 708.* In applying the rules of this section, transfers resulting from a termination of a partnership under section 708(b)(1)(B) are disregarded.

(b) *Transfers treated as a sale*—(1) *In general.* A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances—

(i) The transfer of money or other consideration would not have been made but for the transfer of property; and

(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

(2) *Facts and circumstances.* The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section. Among the facts and circumstances that may tend to prove the existence of a sale under paragraph (b)(1) of this section are the following:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(vi) That a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

(c) *Transfers made within two years presumed to be a sale*—(1) *In general.* For purposes of this section, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

(2) *Disclosure of transfers made within two years.* Disclosure to the Internal Revenue Service in accordance with §1.707–8 is required if—

(i) A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner with a two-year period (without regard to the order of the transfers);

(ii) The partner treats the transfers other than as a sale for tax purposes; and

(iii) The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under §1.707–4(a)(1)(ii), is not a reasonable preferred return within the meaning of §1.707–4(a)(3), and is not an operating cash flow distribution within the meaning of §1.707–4(b)(2).

(d) *Transfers made more than two years apart presumed not to be a sale.* For purposes of this section, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

(e) *Scope.* This section and §§1.707–4 through 1.707–9 apply to contributions and distributions of property described in section 707(a)(2)(A) and transfers described in section 707(a)(2)(B) of the Internal Revenue Code.

(f) *Examples.* The following examples illustrate the application of this section.

Example 1. Treatment of simultaneous transfers as a sale. A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A. Assume that, under this section, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered to have sold a portion of property X with a value of $3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted tax basis ($1,200,000 multiplied by $3,000,000/$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,000,000 of the fair market value of the property with an adjusted tax basis of $300,000.

Example 2. Treatment of transfers at different times as a sale. (i) The facts are the same as in *Example 1,* except that the $3,000,000 is transferred to A one year after A's transfer of property X to the partnership. Assume that under this section the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Assume also that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

(ii) Under paragraph (a)(2) of this section, A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer $3,000,000 to A one year later. Section 1274 applies to this obligation because it does not bear interest and is payable more than six months after the date of the sale. As a result, A's amount realized from the receipt of the partnership's obligation will be the imputed principal amount of the partnership's obligation to transfer $3,000,000 to A, which equals $2,721,088 (the present value on April 9, 1992, of a $3,000,000 payment due one year later, determined using a discount rate of 10 percent, compounded semiannually). Therefore, A's amount realized from the receipt of the partnership's obligation is $2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only $2,721,088 of the fair market value of property X. The remainder of the $3,000,000 payment ($278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize $1,904,761 of gain ($2,721,088 amount realized less $816,327 adjusted tax basis ($1,200,000 multiplied by $2,721,088/$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,278,912 of the fair market value of property X with an adjusted tax basis of $383,673.

Example 3. Operation of presumption for transfers within two years. (i) C transfers undeveloped land to the CD partnership in exchange for an interest in the partnership. The partnership intends to construct a building on the land. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. The partnership agreement provides that upon completing construction of the building the partnership will distribute $900,000 to C.

(ii) If, within two years of C's transfer of land to the partnership, a transfer is made to C pursuant to the provision requiring a distribution upon completion of the building, the transfer is presumed to be, under paragraph (c) of this section, part of a sale of the land to the partnership. C may rebut the presumption that the transfer is part of a sale if the facts and circumstances clearly establish that—

(A) The transfer to C would have been made without regard to C's transfer of land to the partnership; or

(B) The partnership's obligation or ability to make this transfer to C depends, at the time of the transfer to the partnership, on the entrepreneurial risks of partnership operations.

(iii) For example, if the partnership will be able to fund the transfer of cash to C only to the extent that permanent loan proceeds exceed the cost of constructing the building, the fact that excess permanent loan proceeds will be available only if the cost to complete the building is significantly less than the amount projected by a reasonable budget would be evidence that the transfer to C is not part of a sale. Similarly, a condition that limits the amount of the permanent loan to the cost of constructing the building (and thereby limits the partnership's ability to make a transfer to C) unless all or a substantial portion of the building is leased would be evidence that the transfer to C is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. Another factor that may prove that the transfer of cash to C is not part of a sale would be that, at the time the land is transferred to the partnership, no lender has committed to make a permanent loan to fund the transfer of cash to C.

(iv) Facts indicating that the transfer of cash to C is not part of a sale, however, may be offset by other factors. An offsetting factor to restrictions on the permanent loan proceeds may be that the permanent loan is to be a recourse loan and certain conditions to the loan are likely to be waived by the lender because of the creditworthiness of the partners or the value of the partnership's other assets. Similarly, the factor that no lender has committed to fund the transfer of cash to C may be offset by facts establishing that the partnership is obligated to attempt to obtain such a loan and that its ability to obtain such a loan is not significantly dependent on the value that will be added by successful completion of the building, or that the partnership reasonably anticipates that it will have (and will utilize) an alternative source to fund the transfer of cash to C if the permanent loan proceeds are inadequate.

Example 4. Operation of presumption for transfers within two years. E is a partner in the equal EF partnership. The partnership owns two parcels of unimproved real property (*parcels 1 and 2*). Parcels 1 and 2 are unencumbered. Parcel 1 has a fair market value of $500,000, and parcel 2 has a fair market value of $1,500,000. E transfers additional unencumbered, unimproved real property (*parcel 3*) with a fair market value of $1,000,000 to the partnership in exchange for an increased interest in partnership profits of 66⅔ percent. Immediately after this transfer, the partnership sells parcel 1 for $500,000 in a transaction not in the ordinary course of business. The partnership transfers the proceeds of the sale $333,333 to E and $166,667 to F in accordance with their respective partnership interests. The transfer of $333,333 to E is presumed to be, in accordance with paragraph (c) of this section, a sale, in part, of parcel 3 to the partnership. However, the facts of this example clearly establish that $250,000 of the transfer to E is not part of a sale of parcel 3 to the partnership because E would have been distributed $250,000 from the sale of parcel 1 whether or not E had transferred parcel 3 to the partnership. The transfer to E exceeds by $83,333 ($333,333 minus $250,000) the amount of the distribution that would have been made to E if E had not transferred parcel 3 to the partnership. Therefore, $83,333 of the transfer is presumed to be part of a sale of a portion of parcel 3 to the partnership by E.

Example 5. Operation of presumption for transfers more than two years apart. (i) G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. H contributes $1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on the land. The projected construction cost is $5,000,000, which the partnership plans to fund with its $1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.

(ii) Shortly before G's transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of $5,000,000. The partnership is not obligated to reimburse or indemnify H if H must make payment on the completion guarantee. The permanent loan will be funded upon completion of the building, which is expected to occur two years after G's transfer of the land. The amount of the permanent loan is to equal the lesser of $5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G's transfer of the land to the partnership. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed $5,000,000 only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected cost of $5,000,000 approximately two years after G's transfer of the land. Shortly thereafter, the permanent loan is funded in the amount of $5,000,000. At the time of funding the land and building have an appraised value of $7,000,000. The partnership transfers the $1,000,000 excess permanent loan proceeds to G 25 months after G's transfer of the land to the partnership.

(iii) G's transfer of the land to the partnership and the partnership's transfer of $1,000,000 to G occurred more than two years apart. In accordance with paragraph (d) of this section, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale of the property, in whole or part, to the partnership. The transfer of $1,000,000 to G would not have been made but for G's transfer of the land to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time an amount that equals the excess of the permanent loan proceeds over $4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of $4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of $1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G's transfer of the land to the partnership is not treated as part of a sale.

Example 6. Rebuttal of presumption for transfers more than two years apart. The facts are the same as in *Example 5,* except that the partnership is able to secure a commitment for a permanent loan in the amount of $5,000,000 without regard to the appraised value of the improved property at the time the permanent loan is funded. Under these facts, at the time that G transferred the land to the partnership the subsequent transfer of $1,000,000 to G was not dependent on the entrepreneurial risks of partnership operations, because during the period before the permanent loan is funded, the permanent lender's obligation to make a loan in the amount necessary to fund the transfer is not subject to the contingencies related to the risks of partnership operations, and after the permanent loan is funded, the partnership holds liquid assets sufficient to make the transfer. Therefore, the facts and circumstances clearly establish that G's transfer of the land to the partnership is part of a sale.

Example 7. Operation of presumption for transfers more than two years apart. The facts are the same as in *Example 6,* except that H does not guarantee either that the improvements will be completed or that the cost to the partnership of completing the improvements will not exceed $5,000,000. Under these facts, if there is a significant risk that the improvements will not be completed, G's transfer of the land to the partnership will not be treated as part of a sale because the lender is required to make the permanent loan if the improvements are not completed. Similarly, the transfers will not be treated as a sale to the extent that there is a significant risk that the cost of constructing the improvements will exceed $5,000,000, because, in the absence of a guarantee of the cost of the improvements by H, the $5,000,000 proceeds of the permanent loan might not be sufficient to retire the construction loan and fund the transfer to G. In either case, the transfer of cash to G would be dependent on the entrepreneurial risks of partnership operations.

Example 8. Rebuttal of presumption for transfers more than two years apart. (i) On February 1, 1992, I, J, and K form partnership IJK. On formation of the partnership, I transfers an unencumbered office building with a fair market value of $50,000,000 and an adjusted tax basis of $20,000,000 to the partnership, and J and K each transfer United States government securities with a fair market value and an adjusted tax basis of $25,000,000 to the partnership. Substantially all of the rentable space in the office building is leased on a long-term basis. The partnership agreement provides that all items of income, gain, loss, and deduction from the office building are to be allocated 45 percent to J, 45 percent to K, and 10 percent to I. The partnership agreement also provides that all items of income, gain, loss, and deduction from the government securities are to be allocated 90 percent to I, 5 percent to J, and 5 percent to K. The partnership agreement requires that cash flow from the office building and government securities be allocated between partners in the same manner as the items of income, gain, loss, and deduction from those properties are allocated between them. The partnership agreement complies with the requirements of §1.704–1(b)(2)(ii)(*b*). It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the office building. At the time the partnership is formed, I, J, and K contemplated that I's interest in the partnership would be liquidated sometime after January 31, 1994, in exchange for a transfer of the government securities and cash (if necessary). On March 1, 1995, the partnership transfers cash and the government securities to I in liquidation of I's interest in the partnership. The cash transferred to I represents the excess of I's share of the appreciation in the office building since the formation of the partnership over J's and K's share of the appreciation in the government securities since they are acquired by the partnership.

(ii) I's transfer of the office building to the partnership and the partnership's transfer of the government securities and cash to I occurred more than two years apart. Therefore, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale. Absent I's transfer of the office building to the (partnership, I would not have received the government securities from the partnership. The facts including the amount and nature of partnership assets) indicate that, at the time that I transferred the office building to the partnership, the timing of the transfer of the government securities to I was anticipated and was not dependent on the entrepreneurial risks of partnership operations. Moreover, the facts indicate that the partnership allocations were designed to effect an exchange of the burdens and benefits of ownership of the government securities in anticipation of the transfer of those securities to I and those burdens and benefits were effectively shifted to I on formation of the partnership. Accordingly, the facts and circumstances clearly establish that I sold the office building to the partnership on February 1, 1992, in exchange for the partnership's obligation to transfer the government securities to I and to make certain other cash transfers to I.

[T.D. 8439, 57 FR 44978, Sept. 30, 1992]

§ 1.707–4 Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.

(a) *Guaranteed payments and preferred returns*—(1) *Guaranteed payment not treated as part of a sale*—(i) *In general.* A guaranteed payment for capital made to a partner is not treated as part of a sale of property under §1.707–3(a) (relating to treatment of transfers as a sale). A party's characterization of a payment as a guaranteed payment for capital will not control in determining whether a payment is, in fact, a guaranteed payment for capital. The term *guaranteed payment for capital* means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital. See section 707(c). For this purpose, one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.

(ii) *Reasonable guaranteed payments.* Notwithstanding the presumption set forth in § 1.707–3(c) (relating to transfers made within two years of each other), for purposes of section 707(a)(2) and the regulations thereunder a transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the income of the partnership and is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iii) *Unreasonable guaranteed payments.* A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital but that is not reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is a guaranteed payment for capital. A transfer that is not a guaranteed payment for capital is subject to the rules of § 1.707–3.

(2) *Presumption regarding reasonable preferred returns.* Notwithstanding the presumption set forth in § 1.707–3(c) (relating to transfers made within two years of each other), a transfer of money to a partner that is characterized by the parties as a preferred return and that is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be part of a sale of property to the partnership unless the facts and circumstances (including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return) clearly establish that the transfer is part of a sale. The term *preferred return* means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.

(3) *Definition of reasonable preferred returns and guaranteed payments*—(i) *In general.* A transfer of money to a partner that is characterized as a preferred return or guaranteed payment for capital is reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

(ii) *Reasonable amount.* A transfer of money that is made to a partner during any partnership taxable year and is characterized as a preferred return or guaranteed payment for capital is reasonable in amount if the sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner) by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year. A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, transfers of money that are reasonable preferred returns within the meaning of this paragraph (a)(3), and operating cash flow distributions within the meaning of paragraph (b)(2) of this section.

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

Example 1. Transfer presumed to be a guaranteed payment. (i) A transfers property with a fair market value of $100,000 to partnership AB. At the time of A's transfer, the partnership agreement is amended to provide that A is to receive a guaranteed payment for the use of A's capital of 10 percent (compounded annually) of the fair market value of the transferred property in each of the three years following the transfer. The partnership agreement provides that partnership net taxable income and loss will be allocated equally between partners A and B, and that partnership cash flow will be distributed in accordance with the allocation of partnership net taxable income and loss. The partnership would be allowed a deduction in the year paid if the transfers made to A are treated as guaranteed payments under section 707(c). Under the partnership agreement, that deduction would be allocated in the same manner as any other item of partnership deduction. The partnership agreement complies with the requirements of §1.704–1(b)(2)(ii)(*b*). The partnership agreement does not provide for the payment of a preferred return and, other than the guaranteed payment to be paid to A, no transfer is expected to be made during the three year period following A's transfer that is not an operating cash flow distribution (within the meaning of paragraph (b)(2) of this section). Assume that the highest applicable Federal rate in effect at the time of A's transfer is eight percent compounded annually.

(ii) The transfer of money to be made to A under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of §1.707–4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital but is part of a sale.

(iii) The presumption that the transfer is a guaranteed payment for capital is not rebutted, because there are no facts indicating that the transfer is not a guaranteed payment for the use of capital.

Example 2. Transfers characterized as guaranteed payments treated as part of a sale. (i) C and D form partnership CD. C transfers property with a fair market value of $100,000 and an adjusted tax basis of $20,000 in exchange for a partnership interest. D is responsible for managing the day-to-day operations of the partnership and makes no capital contribution to the partnership upon its formation. The partnership agreement provides that C is to receive payments characterized as guaranteed payments and determined without regard to partnership income of $8,333 per year for the first four years of partnership operations for the use of C's capital. In addition, the partnership agreement provides that—

(A) Partnership net taxable income and loss will be allocated 75 percent to C and 25 percent to D; and

(B) All partnership cash flow (determined prior to consideration of the guaranteed payment) will be distributed 75 percent to C and 25 percent to D except that guaranteed payments that the partnership is obligated to make to C are payable solely out of D's share of the partnership's cash flow.

(ii) If D's share of the partnership's cash flow is not sufficient to make the guaranteed payment to C, then D is obligated to contribute any shortfall to the partnership, even in the event the partnership is liquidated. Thus, the effect of the guaranteed payment arrangement is that the guaranteed payment to C is funded entirely by D. The partnership agreement complies with the requirements of §1.704–1(b)(2)(ii)(*b*). Assume that, at the time the partnership is formed, the partnership or D could borrow $25,000 pursuant to a loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of approximately 12 percent (compounded annually). Assume that the highest applicable Federal rate in effect at the time the partnership is formed is 10 percent compounded annually.

(iii) The transfer of money to be made to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of §1.707–4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iv) For the first four years of partnership operations, the total guaranteed payments made to C under the partnership agreement will equal $33,332. If the characterization of those payments as guaranteed payments for capital within the meaning of section 707(c) were respected, C would be allocated $24,999 of the deductions that would be claimed by the partnership for those payments, thereby leaving the balance in C's capital account approximately $25,000 less than it would have been if the guaranteed payments had not been made. The guaranteed payments thus have the effect of offsetting approximately $25,000 of the credit made to C's capital account for the property transferred to the partnership by C. C's resulting capital account is approximately equivalent to the capital account C would have had if C had only contributed 75 percent of the property to the partnership. Furthermore, the effect of D's funding the guaranteed payment to C (either through reduced distributions of cash flow to D or additional contributions) is that D's capital account is approximately equivalent to the capital account D would have had if D had contributed 25 percent of the property (or contributed cash so that the partnership could purchase the 25 percent). Moreover, a $25,000 loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of 12 percent (compounded annually), would have resulted in annual payments of principal and interest of $8,230.86. Consequently, the guaranteed payments effectively place the partners in the same economic position that they would have been in had D purchased a one-quarter interest in the property from C financed at the current market rate of interest, and then C and D each contributed their share of the property to the partnership. In view of the burden the guaranteed payments place on D's right to transfers of partnership cash flow and D's legal obligation to make contributions to the partnership to the extent necessary to fund the guaranteed payments, D has effectively purchased through the partnership a one-quarter interest in the property from C.

(v) Under these facts, the presumption that the transfers to C are guaranteed payments for capital is rebutted, because the facts and circumstances clearly establish that the transfers are part of a sale and not guaranteed payments for capital. Under §1.707–3(a), C and the partnership are treated as if C sold a one-quarter interest in the property to the partnership in exchange for a promissory note evidencing the partnership's obligation to make the guaranteed payments.

(b) *Presumption regarding operating cash flow distributions*—(1) *In general.* Notwithstanding the presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other), an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.

(2) *Operating cash flow distributions*—(i) *In general.* One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions for purposes of paragraph (b)(1) of this section to the extent that those transfers are not presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, are not reasonable preferred returns within the meaning of paragraph (a)(3) of this section, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership. For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by—

(A) Principal payments made on any partnership indebtedness;

(B) Property replacement or contingency reserves actually established by the partnership;

(C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and

(D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

(ii) *Operating cash flow safe harbor.* For any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. This provision is merely intended to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage under the rules of paragraph (b)(2)(i) of this section.

(iii) *Tiered partnerships.* In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in paragraph (b)(2)(i) of this section, so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated.

(c) *Accumulation of guaranteed payments, preferred returns, and operating cash flow distributions.* Guaranteed payments for capital, preferred returns, and operating cash flow distributions presumed not to be part of a sale under the rules of paragraphs (a) and (b) of this section do not lose the benefit of the presumption by reason of being retained for distribution in a later year.

(d) *Exception for reimbursements of preformation expenditures.* A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under § 1.707–3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—

(1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(2) Are incurred by the partner with respect to—

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

(e) *Other exceptions.* The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other payments or transfers to a partner are not treated as part of a sale for purposes of section 707(a)(2) and the regulations thereunder.

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§ 1.707–5 Disguised sales of property to partnership; special rules relating to liabilities.

(a) *Liability assumed or taken subject to by partnership*—(1) *In general.* For purposes of this section and §§ 1.707–3 and 1.707–4, if a partnership assumes or takes property subject to a qualified liability (as defined in paragraph (a)(6) of this section) of a partner, the partnership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability as provided in paragraphs (a) (2), (3) and (4) of this section.

(2) *Partner's share of liability.* A partner's share of any liability of the partnership is determined under the following rules:

(i) *Recourse liability.* A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752–1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

(ii) *Nonrecourse liability.* A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752–3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under § 1.752–1(a)(2) or would be a nonrecourse liability of the partnership under § 1.752–1(a)(2) if it were treated as a partnership liability for purposes of that section.

(3) *Reduction of partner's share of liability.* For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and

(ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under § 1.707–3.

(4) *Special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan.* For purposes of paragraph (a)(1) of this section, if the partnership assumes or takes property or properties subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities (other than that partner's qualified liabilities, as defined in paragraph (a)(6) of this section) assumed or taken subject to by the partnership pursuant to the plan. This paragraph (a)(4) does not apply to any liability assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by the partnership is treated as a transfer of consideration under paragraph (a)(1) of this section.

(5) *Special rule applicable to qualified liabilities.* (i) If a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale. If a transfer of property by a partner to the partnership is treated as part of a sale without regard to the partnership's assumption of or taking subject to a qualified liability (as defined in paragraph (a)(6) of this section) in connection with the transfer of property, the partnership's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partnership only to the extent of the lesser of—

(A) The amount of consideration that the partnership would be treated as transferring to the partner under paragraph (a)(1) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to that property.

(ii) A partner's net equity percentage with respect to an item of property equals the percentage determined by dividing—

(A) The aggregate transfers of money or other consideration to the partner by the partnership (other than any transfer described in this paragraph (a)(5)) that are treated as proceeds realized from the sale of the transferred property; by

(B) The excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering the property or, in the case of any qualified liability described in paragraph (a)(6)(i)(C) or (D) of this section, that is properly allocable to the property.

(6) *Qualified liability of a partner defined.* A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is qualified liability of the partner only to the extend—

(i) The liability is—

(A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfers the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, buy that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of § 1.163–8T to capital expenditures with respect to the property; or

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i) (C) or (D) of this section) at the time of the transfer.

(7) *Liability incurred within two years of transfer presumed to be in anticipation of the transfer*—(i) *In general.* For purposes of this section, if within a two-year period a partner incurs a liability (other than a liability described in paragraph (a)(6)(i) (C) or (D) of this section) and transfers property to a partnership or agrees in writing to transfer the property, and in connection with the transfer the partnership assumes or takes the property subject to the liability, the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.

(ii) *Disclosure of transfers of property subject to liabilities incurred within two years of the transfer.* If a partner treats a liability assumed or taken subject to by a partnership as a qualified liability under paragraph (a)(6)(i)(B) of this section, such treatment is to be disclosed to the Internal Revenue Service in accordance with § 1.707–8.

(b) *Treatment of debt-financed transfers of consideration by partnerships*—(1) *In general.* For purposes of § 1.707–3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under § 1.163–8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

(2) *Partner's allocable share of liability*—(i) *In general.* A partner's allocable share of a partnership liability for purposes of paragraph (b)(1) of this section equals the amount obtained by multiplying the partner's share of the liability as described in paragraph (a)(2) of this section by the fraction determined by dividing—

(A) The portion of the liability that is allocable under § 1.163–8T to the money or other property transferred to the partner; by

(B) The total amount of the liability.

(ii) *Debt-financed transfers made pursuant to a plan*—(A) *In general.* Except as provided in paragraph (b)(2)(iii) of this section, if a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, paragraph (b)(1) of this section is applied by treating all of the liabilities incurred pursuant to the plan as one liability, and each partner's allocable share of those liabilities equals the amount obtained by multiplying the sum of the partner's shares of each of the respective liabilities (as defined in paragraph (a)(2) of this section) by the fraction obtained by dividing—

(*1*) The portion of those liabilities that is allocable under § 1.163–8T to the money or other consideration transferred to the partners pursuant to the plan; by

(*2*) The total amount of those liabilities.

(B) *Special rule.* Paragraph (b)(2)(ii)(A) of this section does not apply to any transfer of money or other property to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under paragraph (b)(1) of this section.

(iii) *Reduction of partner's share of liability.* For purposes of paragraph (b)(2) of this section, a partner's share of a liability, immediately after the partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(A) It is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; and

(B) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale.

(c) *Refinancings.* To the extent that the proceeds of a partner or partnership liability (the *refinancing debt*) are allocable under the rules of § 1.163–8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying the rules of this section.

(d) *Share of liability where assumption accompanied by transfer of money.* For purposes of §§ 1.707–3 through 1.707–5, if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities (other than qualified liabilities) of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced (but not below zero) by the money transferred.

(e) *Tiered partnerships and other related persons.* If a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had under these rules in the upper-tier partnership. A similar rule applies to other related party transactions involving liabilities to the extent provided by guidance published in the Internal Revenue Bulletin.

(f) *Examples.* The following examples illustrate the application of this section.

Example 1. Partnership's assumption of nonrecourse liability encumbering transferred property. (i) A and B form partnership AB, which will engage in renting office space. A transfers $500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of $1,000,000, an adjusted basis of $400,000, and is encumbered by a $500,000 liability, which B incurred 12 months earlier to finance the acquisition of other property. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of section 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse deductions under § 1.752–3(a)(3). The partnership agreement complies with the requirements of § 1.704–1(b)(2)(ii)(*b*).

(ii) The nonrecourse liability secured by the office building is not a qualified liability within the meaning of paragraph (a)(6) of this section. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability equals $250,000, which is equal to B's 50 percent share of the excess nonrecourse liability of the partnership as determined in accordance with B's share of partnership profits under § 1.752–3(a)(3).

(iii) The partnership's taking subject to the liability encumbering the office building is treated as a transfer of $250,000 of consideration to B (the amount by which the liability ($500,000) exceeds B's share of that liability immediately after taking subject to $250,000)). B is treated as having sold $250,000 of the fair market value of the office building to the partnership in exchange for the partnership's taking subject to a $250,000 liability. This results in a gain of $150,000 ($250,000 minus ($250,000/$1,000,000 multiplied by $400,000)).

Example 2. Partnership's assumption of recourse liability encumbering transferred property. (i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire property Y. Under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.

(ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability.

Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)). See paragraphs (a) (1) and (2) of this section.

Example 3. Subsequent reduction of transferring partner's share of liability. (i) The facts are the same as in Example 2. In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time.

(ii) Under paragraph (a)(3) of this section, if the reduction in C's share of the liability was anticipated at the time of C's transfer, and the reduction was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under §1.707–3 (*i.e.*, a principal purpose of allocating a large percentage of losses to C in the first three years when losses were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the assumption is treated as equal to C's reduced share.

Example 4. Trade payables as qualified liabilities. (i) D and E form partnership DE which will engage in a consulting business that requires no overhead and minimal cash on hand for daily operating expenses. Previously, D and E, as individual sole proprietors, operated separate consulting businesses. D and E each transfer to the partnership sufficient cash to cover daily operating expenses together with the goodwill and trade payables related to each sole proprietorship. Due to uncertainty over the collection rate on the trade receivables related to their sole proprietorships, D and E agree that none of the trade receivables will be transferred to the partnership.

(ii) Under the facts of this example, all the assets related to the consulting business (other than the trade receivables) together with the trade payables were transferred to partnership DE. The trade receivables retained by D and E are not material to a continuation of the trade or business by the partnership because D and E contributed sufficient cash to cover daily operating expenses. Accordingly, the trade payables transferred to the partnership constitute qualified liability under paragraph (a)(6) of this section.

Example 5. Partnership's assumption of a qualified liability as sole consideration. (i) F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of $165,000 and an adjusted tax basis of $75,000. Also, at the time of the transfer, property Z is subject to a $75,000 liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that, under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Z, the liability is a recourse liability of the partnership and F's share of that liability is $25,000.

(ii) The $75,000 liability secured by property Z is a qualified liability of F because F incurred the liability more than two years prior to the assumption of the liability by the partnership and the liability has encumbered property Z for more than two years prior to that assumption. *See* paragraph (a)(6) of this section. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, under paragraph (a)(5) of this section, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale.

Example 6. Partnership's assumption of a qualified liability in addition to other consideration. (i) The facts are the same as in *Example 5,* except that the partnership makes a transfer to D of $30,000 in money that is consideration for F's transfer of property Z to the partnership under §1.707–3.

(ii) As in *Example 5,* the $75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred $30,000 to F in addition to assuming the qualified liability under paragraph (a)(5) of this section, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to F if the liability were not a qualified liability ($50,000 (*i.e.,* the excess of the $75,000 qualified liability over F's $25,000 share of that liability)); or

(B) The amount obtained by multiplying the qualified liability ($75,000) by F's net equity percentage with respect to property Z (one-third).

(iii) F's net equity percentage with respect to property Z equals the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under §1.707–3(a) ($30,000 transfer of money); by

(B) F's net equity in property Z ($90,000 (*i.e.,* the excess of the $165,000 fair market value over the $75,000 qualified liability)).

(iv) Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of $25,000 (one-third of $75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold $55,000 of the fair market value of property Z to the partnership in exchange for $30,000 in money and the partnership's assumption of $25,000 of the qualified liability. Accordingly, F must recognize $30,000 of gain on the sale (the excess of the $55,000 amount realized over $25,000 of F's adjusted basis for property, Z (i.e., one-third of F's adjusted basis for the property, because F is treated as having sold one-third of the property to the partnership)).

Example 7. Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan. (i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $10,000 and an adjusted tax basis of $6,000, and property 2 has a fair market value of $10,000 and an adjusted tax basis of $4,000. At the time properties 1 and 2 are transferred to the partnership, a $6,000 nonrecourse liability (*liability 1*) is secured by property 1 and a $7,000 recourse liability of F (*liability 2*) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that G and H are each allocated $2,000 of liability 1 in accordance with §1.707–5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability). Assume further that G's share of liability 2 is $3,500 and H's share is $0 in accordance with §1.707–5(a)(2)(i) (which determines a partner's share of a recourse liability).

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only $500 of consideration to G, (the amount by which liability 1 ($6,000) exceeds G's share of liabilities 1 and 2 ($5,500)), and the partnership's assumption of liability 2 is treated as a transfer of only $5,000 of consideration to H (the amount by which liability 2 ($7,000) exceeds H's share of liabilities 1 and 2 ($2,000)). G is treated under the rule in §1.707–3 as having sold $500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and H is treated as having sold $5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

Example 8. Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability. (i) The facts are the same as in *Example 7,* except that—

(A) H transferred the proceeds of liability 2 to the partnership; and

(B) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G, liability 2 is ignored in applying paragraph (a)(3) of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of $4,000 of consideration to G (the amount by which liability 1 ($6,000) exceeds G's share of liability 1 ($2,000)). On the other hand, the partnership's assumption of liability 2 is not treated as a transfer of any consideration to H because H's share of that liability equals $7,000 as a result of H's transfer of $7,000 in money to the partnership.

Example 9. Partnership's assumptions of qualified liabilities encumbering properties transferred pursuant to a plan in addition to other consideration. (i) Pursuant to a plan, I transfers property 1 and J transfers property 2 plus $10,000 in cash to partnership IJ in exchange for equal interests in the partnership.

At the time the properties are transferred to the partnership, property 1 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $50,000 (*liability 1).* Property 2 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $70,000 (*liability 2).* Pursuant to the plan, the partnership transferred to I $10,000 in cash. That amount is consideration for I's transfer of property 1 to the partnership under § 1.707–3. In accordance with § 1.707–5(a)(2), I and J are each allocated $25,000 of liability 1 and $35,000 of liability 2.

(ii) Because the partnership transferred $10,000 to I as consideration for the transfer of property, under § 1.707–5(a)(5), the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I, even though liability 1 is a qualified liability, to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to I if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the qualified liability by I's net equity percentage with respect to property 1.

(iii) Because I and J transferred properties 1 and 2 to the partnership pursuant to a plan, treating I's qualified liability as a nonqualified liability under § 1.707–5(a)(5)(i)(A) enables I to apply the special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan under § 1.707–5(a)(4). Under this alternative test, the partnership's assumption of liability 1 encumbering property 1 is treated as a transfer of zero ($0) additional consideration to I pursuant to a sale. This is because the amount of liability 1 ($50,000) does not exceed the sum of I's share of liability 1 treated as a nonqualified liability ($25,000) and I's share of liability 2 ($35,000)).

(iv) The alternative under § 1.707–5(a)(5)(i)(B) is the amount obtained by multiplying the qualified liability ($50,000) by I's net equity percentage with respect to property 1. I's net equity percentage with respect to property 1 equals one-fifth, the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to I and treated as part of a sale of property 1 under § 1.707–3(a) (the $10,000 transfer of money; by

(B) I's net equity in property 1 ($50,000 *i.e.*, the excess of the $100,000 fair market value over the $50,000 qualified liability).

(v) Under this alternative test, the partnership's assumption of the qualified liability encumbering property 1 is treated as a transfer of $10,000 (one-fifth of the $50,000 qualified liability) of additional consideration to I pursuant to a sale.

(vi) Applying § 1.707–5(a)(5) to these facts, the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I to the extent of the lesser of—

(A) zero; or

(B) $10,000.

(vii) Therefore, the partnership's assumption of I's qualified liability encumbering property 1 is not treated as a transfer of any additional consideration to I pursuant to a sale, and I is treated as having only received $10,000 of the fair market value of property 1 to the partnership in exchange for $10,000 in cash. Accordingly, I must recognize $9,500 of gain on the sale, that is, the excess of the $10,000 amount realized over $500 of I's adjusted tax basis for property 1 (one-tenth of I's adjusted tax basis for the property, because I is treated as having sold one-tenth of the property to the partnership). Since no other transfer to J was made as consideration for the transfer of property 2, the partnership's assumption of the qualified liability of J encumbering property 2 is not treated as part of a sale.

Example 10. Treatment of debt-financed transfers of consideration by partnership. (i) K transfers property Z to partnership KL in exchange for an interest therein on April 9, 1992. On September 13, 1992, the partnership incurs a liability of $20,000. On November 17, 1992, the partnership transfers $20,000 to K, and $10,000 of this transfer is allocable under the rules of § 1.163–8T to proceeds of the partnership liability incurred on September 13, 1992. The remaining $10,000 is paid from other partnership funds. Assume that, under section 752 and the corresponding regulations, the $20,000 liability incurred on September 13, 1992, is a recourse liability of the partnership and K's share of that liability is $10,000 on November 17, 1992.

(ii) Because a portion of the transfer made to K on November 17, 1992, is allocable under § 1.163–8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and § 1.707–3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the $20,000 liability used to fund $10,000 of the transfer to K is $5,000 (K's share of the liability ($10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K ($10,000); by

(B) The total amount of such liability ($20,000)).

(iii) Therefore, K is required to take into account only $15,000 of the $20,000 partnership transfer to K for purposes of this section and § 1.707–3. Under these facts, assuming the within-two-year presumption is not rebutted, this $15,000 transfer will be treated under the rule in § 1.707–3 as part of a sale by K of property Z to the partnership.

Example 11. Borrowing against pool of receivables. (i) M generates receivables which have an adjusted basis of zero in the ordinary course of its business. For M to use receivables as security for a loan, a commercial lender requires M to transfer the receivables to a partnership in which M has a 90 percent interest. In January, 1992, M transfers to the partnership receivables with a face value of $100,000. N (who is not related to M) transfers $10,000 cash to the partnership in exchange for a 10 percent interest. The partnership borrows $80,000, secured by the receivables, and makes a distribution of $72,000 of the proceeds to M and $8,000 of the proceeds to N within 90 days of incurring the liability. M's share of the liability under §1.707–5(a)(2) is $72,000 (90 percent×$80,000).

(ii) Because the transfer of the loan proceeds to M is allocable under §1.163–8T to proceeds of a partnership loan that was incurred by the partnership within 90 days of that transfer, M is required to take the transfer into account in applying the rules of this section and §1.707–3 only to the extent that the amount of the transfer ($72,000) exceeds M's allocable share of the liability used to fund the transfer. Because the distribution was a debt-financed transfer pursuant to a plan, M's allocable share of the liability is $72,000 ($72,000×$80,000/80,000) under §1.707–5(b)(2)(ii). Therefore, M is not required to take into account any of the loan proceeds for purposes of this section and §1.707–3.

(iii) When the receivables are collected, M must be allocated the gain on the contributed receivables under section 704(c). However, the lender permits the partnership to distribute cash to the partners only to the extent of the value of new receivables contributed to the partnership. In 1993, M contributes additional receivables and receives a distribution of cash. The taxable income recognized by the partnership on the receivables is taxable income of the partnership arising in the ordinary course of the partnership's activities. To the extent the distribution does not exceed 90 percent (M's percentage interest in overall partnership profits) of the partnership's operating cash flow under §1.707–4(b), the distribution to M is presumed not to be a part of a sale of receivables by M to the partnership, and the presumption is not rebutted under these facts.

[T.D. 8439, 57 FR 44983, Sept. 30, 1992]

§ 1.707–6 Disguised sales of property by partnership to partner; general rules.

(a) *In general.* Rules similar to those provided in §1.707–3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

(b) *Special rules relating to liabilities*—(1) *In general.* Rules similar to those provided in §1.707–5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale. Accordingly, if a partner assumes or takes property subject to a qualified liability (as defined in paragraph (b)(2) of this section) of a partnership, the partner is treated as transferring consideration to the partnership only to the extent provided in paragraph (b). If the partner assumes or takes subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability (determined under the rules of §1.707–5(a)(2)) immediately before the transfer. Similar to the rules provided in §1.707–5(a)(4), if more than one partner assumes or takes subject to a liability pursuant to a plan, the amount that is treated as a transfer of consideration by each partner is the amount by which all of the liabilities (other than qualified liabilities) assumed or taken subject to by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption or taking subject to. This paragraph (b)(1) does not apply to any liability assumed or taken subject to by a partner with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by a partner is treated as a transfer of consideration under this paragraph (b).

(2) *Qualified liabilities.* (i) If a transfer of property by a partnership to a partner is not otherwise treated as part of a sale, the partner's assumption of or taking subject to a qualified liability is not treated as part of a sale. If a transfer of property by a partnership to the partner is treated as part of a sale without regard to the partner's assumption of or taking subject to a

qualified liability, the partner's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partner only to the extent of the lesser of—

(A) The amount of consideration that the partner would be treated as transferring to the partnership under paragraph (b) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the liability at the time of its assumption or taking subject to by the partnership's net equity percentage with respect to that property.

(ii) A partnership's net equity percentage with respect to an item of property encumbered by a qualified liability equals the percentage determined by dividing—

(A) The aggregate transfers to the partnership from the partner (other than any transfer described in this paragraph (b)(2)) that are treated as the proceeds realized from the sale of the transferred property to the partner; by

(B) The excess of the fair market value of the property at the time it is transferred to the partner over any qualified liabilities of the partnership that are assumed or taken subject to by the partner at that time.

(iii) For purposes of this section, the definition of a qualified liability is that provided in §1.707–5(a)(6) with the following exceptions—

(A) In applying the definition, the qualified liability is one that is originally an obligation of the partnership and is assumed or taken subject to by the partner in connection with a transfer of property to the partner; and

(B) If the liability was incurred by the partnership more than two years prior to the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property to the partner, that liability is a qualified liability whether or not it has encumbered the transferred property throughout the two-year period.

(c) *Disclosure rules.* Similar to the rules provided in §§1.707–3(c)(2) and 1.707–5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with §1.707–8, the facts in the following circumstances:

(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and

(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership agrees in writing to the transfer of property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to §1.707–5(a)(6)(i)(B).

(d) *Examples.* The following examples illustrate the rules of this section.

Example 1. Sale of property by partnership to partner. (i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.

(ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in §1.707–3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers property X to A, the partnership is treated as having sold property X to A in exchange for A's obligation to transfer $1,100,000 to the partnership one year later.

Example 2. Assumption of liability by partner. (i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under rule of §1.707–5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability), B's share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of §1.163–8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in §1.707–5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B's share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B's capacity as a partner, the other one-half of property Y.

[T.D. 8439, 57 FR 44987, Sept. 30, 1992]

§1.707–7 Disguised sales of partnership interests. [Reserved]

§1.707–8 Disclosure of certain information.

(a) *In general.* The disclosure referred to in §1.707–3(c)(2) (regarding certain transfers made within two years of each other), §1.707–5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), and §1.707–6(c) (relating to transfers of property from a partnership to a partner in situations analogous to those listed above) is to be made in accordance with paragraph (b) of this section.

(b) *Method of providing disclosure.* Disclosure is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer that includes the following:

(1) A caption identifying the statement as disclosure under section 707;

(2) An identification of the item (or group of items) with respect to which disclosure is made;

(3) The amount of each item; and

(4) The facts affecting the potential tax treatment of the item (or items) under section 707.

(c) *Disclosure by certain partnerships.* If more than one partner transfers property to a partnership pursuant to a plan, the disclosure required by this section may be made by the partnership on behalf of all the transferors rather than by each transferor separately.

[T.D. 8439, 57 FR 44988, Sept. 30, 1992]

§1.707–9 Effective dates and transitional rules.

(a) *Sections 1.707–3 through 1.707–6*—(1) *In general.* Except as provided in paragraph (a)(3) of this section, §§1.707–3 through 1.707–6 apply to any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991.

(2) *Transfers occurring on or before April 24, 1991.* Except as otherwise provided in paragraph (a)(3) of this section, in the case of any transaction with respect to which one or more of the transfers occurs on or before April 24, 1991, the determination of whether the transaction is a disguised sale of property (including a partnership interest) under section 707(a)(2) is to be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 73 of the Tax Reform Act of 1984 (Pub. L. 98–369, 98 Stat. 494). See H.R. Rep. No. 861, 98th Cong., 2d Sess. 859–62 (1984); S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 223–32 (1984); H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216–21 (1984).

(3) *Effective date of section 73 of the Tax Reform Act of 1984.* Sections 1.707–3 through 1.707–6 do not apply to any transfer of money or other consideration to which section 73(a) of the Tax Reform Act of 1984 (Pub. L. 98–369, 98 Stat. 494) does not apply pursuant to section 73(b) of that Act.

(b) *Section 1.707–8 disclosure of certain information.* The disclosure provisions described in §1.707–8 apply to transactions with respect to which all transfers that are part of a sale of property occur after September 30, 1992.

[T.D. 8439, 57 FR 44989, Sept. 30, 1992]

§ 1.708–1 Continuation of partnership.

(a) *General rule.* For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) *Termination*—(1) *General rule.* A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

(i) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

(ii) For the continuation of a partnership where payments are being made under section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), see paragraph (a)(6) of § 1.736–1.

(2) A partnership shall terminate when 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a period of 12 consecutive months. Such sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this subparagraph. Moreover, if the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership. The previous two sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner. Furthermore, the contribution of property to a partnership does not constitute such a sale or exchange. See, however, paragraph (c)(3) of § 1.731–1. Fifty percent or more of the total interest in partnership capital and profits means 50 percent or more of the total interest in partnership capital plus 50 percent or more of the total interest in partnership profits. Thus, the sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits is not the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If one or more partners sell or exchange interests aggregating 50 percent or more of the total interest in partnership capital and 50 percent or more of the total interest in partnership profits within a period of 12 consecutive months, such sale or exchange is considered as being within the provisions of this subparagraph. When interests are sold or exchanged on different dates, the percentages to be added are determined as of the date of each sale. For example, with respect to the ABC partnership, the sale by A on May 12, 1956, of a 30-percent interest in capital and profits to D, and the sale by B on March 27, 1957, of a 30-percent interest in capital and profits to E, is a sale of a 50-percent or more interest. Accordingly, the partnership is terminated as of March 27, 1957. However, if, on March 27, 1957,

D instead of B, sold his 30-percent interest in capital and profits to E, there would be no termination since only one 30-percent interest would have been sold or exchanged within a 12-month period.

(3) For purposes of subchapter K, chapter 1 of the Code, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates. See section 706(c)(1) and paragraph (c)(1) of § 1.706–1. The date of termination is:

(i) For purposes of section 708(b)(1)(A), the date on which the winding up of the partnership affairs is completed.

(ii) For purposes of section 708(b)(1)(B), the date of the sale or exchange of a partnership interest which, of itself or together with sales or exchanges in the preceding 12 months, transfers an interest of 50 percent or more in both partnership capital and profits.

(4) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with (b)(1) of this section. This paragraph (b)(4) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(4) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(4) to the termination in a consistent manner. The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) A and B each contribute $10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time A sells its entire 50 percent interest to C for $15,000 in a transfer that terminates the partnership under section 708(b)(1)(B). At the time of the sale, Property X had an adjusted tax basis of $16,000 and a book value of $16,000 (original $20,000 tax basis and book value reduced by $4,000 of depreciation). In addition, A and B each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).

(ii) Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted tax basis of Property X in the hands of new AB is $16,000. See Section 723. The book value of Property X in the hands of new partnership AB is also $16,000 (the book value of Property X immediately before the termination) and B and C each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB prior to the termination). See § 1.704–1(b)(2)(iv)(*l*) (providing that the deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership). Additionally, under § 301.6109–1(d)(2)(iii) of this chapter, new AB retains the taxpayer identification number of the terminated AB partnership.

(iii) Property X was not section 704(c) property in the hands of terminated AB and is therefore not treated as section 704(c) property in the hands of new AB, even though Property X is deemed contributed to new AB at a time when the fair market value of Property X ($30,000) was different from its adjusted tax basis ($16,000). See § 1.704–3(a)(3)(i) (providing that property contributed to a new partnership under § 1.708–1(b)(4) is treated as section 704(c) property only to the extent that the property was section 704(c) property in the hands of the terminated partnership immediately prior to the termination).

(5) If a partnership is terminated by a sale or exchange of an interest in the partnership, a section 754 election (including a section 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. Therefore, the bases of partnership assets are adjusted pursuant to sections 743 and 755 prior to their deemed contribution to the new partnership. This paragraph

(b)(5) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (b)(5) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (b)(5) to the termination in a consistent manner.

(c) *Merger or consolidation*—(1) *General rule.* If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall, unless the Commissioner permits otherwise, be considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.

(2) *Tax returns.* The taxable years of any merging or consolidating partnerships which are considered terminated shall be closed in accordance with the provisions of section 706(c) and the regulations thereunder, and such partnerships shall file their returns for a taxable year ending upon the date of termination, *i.e.*, the date of merger or consolidation. The resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing. The return shall state that the resulting partnership is a continuation of such merging or consolidating partnership, shall retain the employer identification number (EIN) of the partnership that is continuing, and shall include the names, addresses, and EINs of the other merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and including the date of the merger or consolidation and subsequent to the date of merger or consolidation shall be shown as a part of the return.

(3) *Form of a merger or consolidation*—(i) *Assets-over form.* When two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not described in paragraph (c)(3)(ii) of this section, any merged or consolidated partnership that is considered terminated under paragraph (c)(1) of this section is treated as undertaking the assets-over form for Federal income tax purposes. Under the assets-over form, the merged or consolidated partnership that is considered terminated under paragraph (c)(1) of this section contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.

(ii) *Assets-up form.* Despite the partners' transitory ownership of the terminated partnership's assets, the form of a partnership merger or consolidation will be respected for Federal income tax purposes if the merged or consolidated partnership that is considered terminated under paragraph (c)(1) of this section distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.

(4) *Sale of an interest in the merging or consolidating partnership.* In a transaction characterized under the assets-over form, a sale of all or part of a partner's interest in the terminated

partnership to the resulting partnership that occurs as part of a merger or consolidation under section 708(b)(2)(A), as described in paragraph (c)(3)(i) of this section, will be respected as a sale of a partnership interest if the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold, and if the selling partner in the terminated partnership, either prior to or contemporaneous with the transaction, consents to treat the transaction as a sale of the partnership interest. See section 741 and §1.741–1 for determining the selling partner's gain or loss on the sale or exchange of the partnership interest.

(5) *Examples.* The following examples illustrate the rules in paragraphs (c)(1) through (4) of this section:

Example 1. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September 30, 1999, and form partnership ABCD. Partners A, B, C, and D are on a calendar year, and partnership AB and partnership CD also are on a calendar year. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. Since A and B together own an interest of more than 50 percent in the capital and profits of partnership ABCD, such partnership shall be considered a continuation of partnership AB and shall continue to file returns on a calendar year basis. Since C and D own an interest of less than 50 percent in the capital and profits of partnership ABCD, the taxable year of partnership CD closes as of September 30, 1999, the date of the merger, and partnership CD is terminated as of that date. Partnership ABCD is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that, until September 30, 1999, it was partnership AB. Partnership CD is required to file a return for its final taxable year, January 1 through September 30, 1999.

Example 2. (i) Partnership X, in whose capital and profits A owns a 40-percent interest and B owns a 60-percent interest, and partnership Y, in whose capital and profits B owns a 60-percent interest and C owns a 40-percent interest, merge on September 30, 1999. The fair market value of the partnership X assets (net of liabilities) is $100X, and the fair market value of the partnership Y assets (net of liabilities) is $200X. The merger is accomplished under state law by partnership Y contributing its assets and liabilities to partnership X in exchange for interests in partnership X, with partnership Y then liquidating, distributing interests in partnership X to B and C.

(ii) B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, because the fair market value of partnership Y's assets (net of liabilities) was greater than that of partnership X's, under paragraph (c)(1) of this section, partnership X will be considered to terminate in the merger. As a result, even though, for state law purposes, the transaction was undertaken with partnership Y contributing its assets and liabilities to partnership X and distributing interests in partnership X to its partners, pursuant to paragraph (c)(3)(i) of this section, for Federal income tax purposes, the transaction will be treated as if partnership X contributed its assets to partnership Y in exchange for interests in partnership Y and then liquidated, distributing interests in partnership Y to A and B.

Example 3. (i) The facts are the same as in *Example 2,* except that partnership X is engaged in a trade or business and has, as one of its assets, goodwill. In addition, the merger is accomplished under state law by having partnership X convey an undivided 40-percent interest in each of its assets to A and an undivided 60-percent interest in each of its assets to B, with A and B then contributing their interests in such assets to partnership Y. Partnership Y also assumes all of the liabilities of partnership X.

(ii) Under paragraph (c)(3)(ii) of this section, the form of the partnership merger will be respected so that partnership X will be treated as following the assets-up form for Federal income tax purposes.

Example 4. (i) Partnership X and partnership Y merge when the partners of partnership X transfer their partnership X interests to partnership Y in exchange for partnership Y interests. Immediately thereafter, partnership X liquidates into partnership Y. The resulting partnership is considered a continuation of partnership Y, and partnership X is considered terminated.

(ii) The partnerships are treated as undertaking the assets-over form described in paragraph (c)(3)(i) of this section because the partnerships undertook a form that is not the assets-up form described in paragraph (c)(3)(ii) of this section. Accordingly, for Federal income tax purposes, partnership X is deemed to contribute its assets and liabilities to partnership Y in exchange for interests in partnership Y, and, immediately thereafter, partnership X is deemed to have distributed the interests in partnership Y to its partners in liquidation of their interests in partnership X.

Example 5. (i) A, B, and C are partners in partnership X. D, E, and F are partners in Partnership Y. Partnership X and partnership Y merge, and the resulting partnership is considered a continuation of partnership Y. Partnership X is considered terminated. Under state law, partnerships X and Y undertake the assets-over form of paragraph (c)(3)(i) of this section to accomplish the partnership merger. C does not want to become a partner in partnership Y, and partnership X does not have the resources to buy C's interest before the merger. C, partnership X, and partnership Y enter into an agreement specifying that partnership Y will purchase C's interest in partnership X for $150 before the merger, and as part of the agreement, C consents to treat the transaction in a manner that is consistent with the agreement. As part of the merger, partnership X receives from partnership Y $150 that will be distributed to C immediately before the merger, and interests in partnership Y in exchange for partnership X's assets and liabilities.

(ii) Because the merger agreement satisfies the requirements of paragraph (c)(4) of this section and C provides the necessary consent, C will be treated as selling its interest in partnership X to partnership Y for $150 before the merger. See section 741 and §1.741–1 to determine the amount and character of C's gain or loss on the sale or exchange of its interest in partnership X.

(iii) Because the merger agreement satisfies the requirements of paragraph (c)(4) of this section, partnership Y is considered to have purchased C's interest in partnership X for $150 immediately before the merger. See §1.704–1(b)(2)(iv)(*l*) for determining partnership Y's capital account in partnership X. Partnership Y's adjusted basis of its interest in partnership X is determined under section 742 and §1.742–1. To the extent any built-in gain or loss on section 704(c) property in partnership X would have been allocated to C (including any allocations with respect to property revaluations under section 704(b) (reverse section 704(c) allocations)), see section 704 and §1.704–3(a)(7) for determining the built-in gain or loss or reverse section 704(c) allocations apportionable to partnership Y. Similarly, after the merger is completed, the built-in gain or loss and reverse section 704(c) allocations attributable to C's interest are apportioned to D, E, and F under section 704(c) and §1.704–3(a)(7).

(iv) Under paragraph (c)(3)(i) of this section, partnership X contributes its assets and liabilities attributable to the interests of A and B to partnership Y in exchange for interests in partnership Y; and, immediately thereafter, partnership X distributes the interests in partnership Y to A and B in liquidation of their interests in partnership X. At the same time, partnership X distributes assets to partnership Y in liquidation of partnership Y's interest in partnership X. Partnership Y's bases in the distributed assets are determined under section 732(b).

(6) *Prescribed form not followed in certain circumstances.* (i) If any transactions described in paragraph (c)(3) or (4) of this section are part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form prescribed in such paragraph, the Commissioner may disregard such form, and may recast the larger series of transactions in accordance with their substance.

(ii) *Example.* The following example illustrates the rules in paragraph (c)(6) of this section:

Example. A, B, and C are equal partners in partnership ABC. ABC holds no section 704(c) property. D and E are equal partners in partnership DE. B and C want to exchange their interests in ABC for all of the interests in DE. However, rather than exchanging partnership interests, DE merges with ABC by undertaking the assets-up form described in paragraph (c)(3)(ii) of this section, with D and E receiving title to the DE assets and then contributing the assets to ABC in exchange for interests in ABC. As part of a prearranged transaction, the assets acquired from DE are contributed to a new partnership, and the interests in the new partnership are distributed to B and C in complete liquidation of their interests in ABC. The merger and division in this example represent a series of transactions that in substance are an exchange of interests in ABC for interests in DE. Even though paragraph (c)(3)(ii) of this section provides that the form of a merger will be respected for Federal income tax purposes if the steps prescribed under the assets-up form are followed, and paragraph (d)(3)(i) of this section provides a form that will be followed for Federal income tax purposes in the case of partnership divisions, these forms will not be respected for Federal income tax purposes under these facts, and the transactions will be recast in accordance with their substance as a taxable exchange of interests in ABC for interests in DE.

(7) *Effective date.* This paragraph (c) is applicable to partnership mergers occurring on or after January 4, 2001. However, a partnership may apply paragraph (c) of this section to partnership mergers occurring on or after January 11, 2000.

(d) *Division of a partnership*—(1) *General rule.* Upon the division of a partnership into two or more partnerships, any resulting partnership (as defined in paragraph (d)(4)(iv) of this section) or resulting partnerships shall be considered a continuation of the prior partnership (as defined in paragraph (d)(4)(ii) of this section) if the members of the resulting partnership or partnerships had an interest of more than 50 percent in the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the prior partnership, none of the resulting partnerships will be considered a continuation of the prior partnership, and the prior partnership will be considered to have terminated. Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partnership, such members' interests shall be considered liquidated as of the date of the division.

(2) *Tax consequences*—(i) *Tax returns.* The resulting partnership that is treated as the divided partnership (as defined in paragraph (d)(4)(i) of this section) shall file a return for the taxable year of the partnership that has been divided and retain the employer identification number (EIN) of the prior partnership. The return shall include the names, addresses, and EINs of all resulting partnerships that are regarded as continuing. The return shall also state that the partnership is a continuation of the prior partnership and shall set forth separately the respective distributive shares of the partners for the periods prior to and including the date of the division and subsequent to the date of division. All other resulting partnerships that are regarded as continuing and new partnerships shall file separate returns for the taxable year beginning on the day after the date of the division with new EINs for each partnership. The return for a resulting partnership that is regarded as continuing and that is not the divided partnership shall include the name, address, and EIN of the prior partnership.

(ii) *Elections.* All resulting partnerships that are regarded as continuing are subject to preexisting elections that were made by the prior partnership. A subsequent election that is made by a resulting partnership does not affect the other resulting partnerships.

(3) *Form of a division*—(i) *Assets-over form.* When a partnership divides into two or more partnerships under applicable jurisdictional law without undertaking a form for the division, or undertakes a form that is not described in paragraph (d)(3)(ii) of this section, the transaction will be characterized under the assets-over form for Federal income tax purposes.

(A) *Assets-over form where at least one resulting partnership is a continuation of the prior partnership.* In a division under the assets-over form where at least one resulting partnership is a continuation of the prior partnership, the divided partnership (as defined in paragraph (d)(4)(i) of this section) contributes certain assets and liabilities to a recipient partnership (as defined in paragraph (d)(4)(iii) of this section) or recipient partnerships in exchange for interests in such recipient partnership or partnerships; and, immediately thereafter, the divided partnership distributes the interests in such recipient partnership or partnerships to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.

(B) *Assets-over form where none of the resulting partnerships is a continuation of the prior partnership.* In a division under the assets-over form where none of the resulting partnerships is a continuation of the prior partnership, the prior partnership will be treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships; and, immediately thereafter, the prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership's partners.

(ii) *Assets-up form*—(A) *Assets-up form where the partnership distributing assets is a continuation of the prior partnership.*

Despite the partners' transitory ownership of some of the prior partnership's assets, the form of a partnership division will be respected for Federal income tax purposes if the divided partnership (which, pursuant to §1.708–1(d)(4)(i), must be a continuing partnership) distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership, and immediately thereafter, such partners contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership or partnerships. In order for such form to be respected for transfers to a particular recipient partnership, all assets held by the prior partnership that are transferred to the recipient partnership must be distributed to, and then contributed by, the partners of the recipient partnership.

(B) *Assets-up form where none of the resulting partnerships are a continuation of the prior partnership.* If none of the resulting partnerships are a continuation of the prior partnership, then despite the partners' transitory ownership of some or all of the prior partnership's assets, the form of a partnership division will be respected for Federal income tax purposes if the prior partnership distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the prior partnership, and immediately thereafter, such partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests in such resulting partnership or partnerships. In order for such form to be respected for transfers to a particular resulting partnership, all assets held by the prior partnership that are transferred to the resulting partnership must be distributed to, and then contributed by, the partners of the resulting partnership. If the prior partnership does not liquidate under the applicable jurisdictional law, then with respect to the assets and liabilities that, in form, are not transferred to a new resulting partnership, the prior partnership will be treated as transferring these assets and liabilities to a new resulting partnership under the assets-over form described in paragraph (d)(3)(i)(B) of this section.

(4) *Definitions*—(i) *Divided partnership.* For purposes of paragraph (d) of this section, the divided partnership is the continuing partnership which is treated, for Federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form). If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships without undertaking a form for the division that is recognized under paragraph (d)(3) of this section, or if the resulting partnership that had, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.

(ii) *Prior partnership.* For purposes of paragraph (d) of this section, the prior partnership is the partnership subject to division that exists under applicable jurisdictional law before the division.

(iii) *Recipient partnership.* For purposes of paragraph (d) of this section, a recipient partnership is a partnership that is treated as receiving, for Federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form).

(iv) *Resulting partnership.* For purposes of paragraph (d) of this section, a resulting partnership is a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership. For example, where a prior partnership divides into two partnerships, both partnerships existing after the division are resulting partnerships.

(5) *Examples.* The following examples illustrate the rules in paragraphs (d)(1), (2), (3), and (4) of this section:

Example 1. Partnership ABCD is in the real estate and insurance businesses. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of the partnership. The partnership and the partners report their income on a calendar year. On November 1, 1999, they separate the real estate and insurance businesses and form two partnerships. Partnership AB takes over the real estate business, and partnership CD takes over the insurance business. Because members of resulting partnership AB owned more than a 50-percent interest in the capital and profits of partnership ABCD (A, 40 percent, and B, 20 percent), partnership AB shall be considered a continuation of partnership ABCD. Partnership AB is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that until November 1, 1999, it was partnership ABCD. Partnership CD is considered a new partnership formed at the beginning of the day on November 2, 1999, and is required to file a return for the taxable year it adopts pursuant to section 706(b) and the applicable regulations.

Example 2. (i) Partnership ABCD owns properties W, X, Y, and Z, and divides into partnership AB and partnership CD. Under paragraph (d)(1) of this section, partnership AB is considered a continuation of partnership ABCD and partnership CD is considered a new partnership. Partnership ABCD distributes property Y to C and titles property Y in C's name. Partnership ABCD distributes property Z to D and titles property Z in D's name. C and D then contribute properties Y and Z, respectively, to partnership CD in exchange for interests in partnership CD. Properties W and X remain in partnership AB.

(ii) Under paragraph (d)(3)(ii) of this section, partnership ABCD will be treated as following the assets-up form for Federal income tax purposes.

Example 3. (i) The facts are the same as in *Example 2,* except partnership ABCD distributes property Y to C and titles property Y in C's name. C then contributes property Y to partnership CD. Simultaneously, partnership ABCD contributes property Z to partnership CD in exchange for an interest in partnership CD. Immediately thereafter, partnership ABCD distributes the interest in partnership CD to D in liquidation of D's interest in partnership ABCD.

(ii) Under paragraph (d)(3)(i) of this section, because partnership ABCD did not undertake the assets-up form with respect to all of the assets transferred to partnership CD, partnership ABCD will be treated as undertaking the assets-over form in transferring the assets to partnership CD. Accordingly, for Federal income tax purposes, partnership ABCD is deemed to contribute property Y and property Z to partnership CD in exchange for interests in partnership CD, and immediately thereafter, partnership ABCD is deemed to distribute the interests in partnership CD to partner C and partner D in liquidation of their interests in partnership ABCD.

Example 4. (i) Partnership ABCD owns three parcels of property: property X, with a value of $500; property Y, with a value of $300; and property Z, with a value of $200. A and B each own a 40-percent interest in the capital and profits of partnership ABCD, and C and D each own a 10 percent interest in the capital and profits of partnership ABCD. On November 1, 1999, partnership ABCD divides into three partnerships (AB1, AB2, and CD) by contributing property X to a newly formed partnership (AB1) and distributing all interests in such partnership to A and B as equal partners, and by contributing property Z to a newly formed partnership (CD) and distributing all interests in such partnership to C and D as equal partners in exchange for all of their interests in partnership ABCD. While partnership ABCD does not transfer property Y, C and D cease to be partners in the partnership. Accordingly, after the division, the partnership holding property Y is referred to as partnership AB2.

(ii) Partnerships AB1 and AB2 both are considered a continuation of partnership ABCD, while partnership CD is considered a new partnership formed at the beginning of the day on November 2, 1999. Under paragraph (d)(3)(i)(A) of this section, partnership ABCD will be treated as following the assets-over form, with partnership ABCD contributing property X to partnership AB1 and property Z to partnership CD, and distributing the interests in such partnerships to the designated partners.

Example 5. (i) The facts are the same as in *Example 4*, except that partnership ABCD divides into three partnerships by operation of state law, without undertaking a form.

(ii) Under the last sentence of paragraph (d)(4)(i) of this section, partnership AB1 will be treated as the resulting partnership that is the divided partnership. Under paragraph (d)(3)(i)(A) of this section, partnership ABCD will be treated as following the assets-over form, with partnership ABCD contributing property Y to partnership AB2 and property Z to partnership CD, and distributing the interests in such partnerships to the designated partners.

Example 6. (i) The facts are the same as in *Example 4*, except that partnership ABCD divides into three partnerships by contributing property X to newly-formed partnership AB1 and property Y to newly-formed partnership AB2 and distributing all interests in each partnership to A and B in exchange for all of their interests in partnership ABCD.

(ii) Because resulting partnership CD is not a continuation of the prior partnership (partnership ABCD), partnership CD cannot be treated, for Federal income tax purposes, as the partnership that transferred assets (*i.e.*, the divided partnership), but instead must be treated as a recipient partnership. Under the last sentence of paragraph (d)(4)(i) of this section, partnership AB1 will be treated as the resulting partnership that is the divided partnership. Under paragraph (d)(3)(i)(A) of this section, partnership ABCD will be treated as following the assets-over form, with partnership ABCD contributing property Y to partnership AB2 and property Z to partnership CD, and distributing the interests in such partnerships to the designated partners.

Example 7. (i) Partnership ABCDE owns Blackacre, Whiteacre, and Redacre, and divides into partnership AB, partnership CD, and partnership DE. Under paragraph (d)(1) of this section, partnership ABCDE is considered terminated (and, hence, none of the resulting partnerships are a continuation of the prior partnership) because none of the members of the new partnerships (partnership AB, partnership CD, and partnership DE) owned an interest of more than 50 percent in the capital and profits of partnership ABCDE.

(ii) Partnership ABCDE distributes Blackacre to A and B and titles Blackacre in the names of A and B. A and B then contribute Blackacre to partnership AB in exchange for interests in partnership AB. Partnership ABCDE will be treated as following the assets-up form described in paragraph (d)(3)(ii)(B) of this section for Federal income tax purposes.

(iii) Partnership ABCDE distributes Whiteacre to C and D and titles Whiteacre in the names of C and D. C and D then contribute Whiteacre to partnership CD in exchange for interests in partnership CD. Partnership ABCDE will be treated as following the assets-up form described in paragraph (d)(3)(ii)(B) of this section for Federal income tax purposes.

(iv) Partnership ABCDE does not liquidate under state law so that, in form, the assets in new partnership DE are not considered to have been transferred under state law. Partnership ABCDE will be treated as undertaking the assets-over form described in paragraph (d)(3)(i)(B) of this section for Federal income tax purposes with respect to the assets of partnership DE. Thus, partnership ABCDE will be treated as contributing Redacre to partnership DE in exchange for interests in partnership DE; and, immediately thereafter, partnership ABCDE will be treated as distributing interests in partnership DE to D and E in liquidation of their interests in partnership ABCDE. Partnership ABCDE then terminates.

(6) *Prescribed form not followed in certain circumstances.* If any transactions described in paragraph (d)(3) of this section are part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form prescribed in such paragraph, the Commissioner may disregard such form, and may recast the larger series of transactions in accordance with their substance.

(7) *Effective date.* This paragraph (d) is applicable to partnership divisions occurring on or after January 4, 2001. However, a partnership may apply paragraph (d) of this section to partnership divisions occurring on or after January 11, 2000.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8717, 62 FR 25500, May 9, 1997; T.D. 8925, 65 FR 719, Jan. 4, 2001; 67 FR 57330, Sept. 10, 2002]

§ 1.709–1 Treatment of organization and syndication costs.

(a) *General rule.* Except as provided in paragraph (b) of this section, no deduction shall be allowed under chapter 1 of the Code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, 1975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

(b) *Amortization of organization expenses.* (1) Under section 709(b) of the Code, a partnership may elect to treat its organizational expenses (as defined in section 709(b)(2) and in § 1.709–2(a)) paid or incurred in partnership taxable years beginning after December 31, 1976, as deferred expenses. If a partnership elects to amortize organizational expenses, it must select a period of not less than 60 months, over which the partnership will amortize all such expenses on a straight line basis. This period must begin with the month in which the partnership begins business (as determined under § 1.709–2(c)). However, in the case of a partnership on the cash receipts and disbursements method of accounting, no deduction shall be allowed for a taxable year with respect to any such expenses that have not been paid by the end of that taxable year. Portions of such expenses which would have been deductible under section 709(b) in a prior taxable year if the expenses had been paid are deductible in the year of payment. The election is irrevocable and the period selected by the partnership in making its election may not be subsequently changed.

(2) If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to its capitalized syndication expenses.

(c) *Time and manner of making election.* The election to amortize organizational expenses provided by section 709(b) shall be made by attaching a statement to the partnership's return of income for the taxable year in which the partnership begins business. The statement shall set forth a description of each organizational expense incurred (whether or not paid) with the amount of the expense, the date each expense was incurred, the month in which the partnership began business, and the number of months (not less than 60) over which the expenses are to be amortized. A taxpayer on the cash receipts and disbursements method of accounting shall also indicate the amount paid before the end of the taxable year with respect to each such expense. Expenses less than $10 need not be separately listed, provided the total amount of these expenses is listed with the dates on which the first and last of such expenses were incurred, and, in the case of a taxpayer on the cash receipts and disbursements method of accounting, the aggregate amount of such expenses that was paid by the end of the taxable year is stated. In the case of a partnership which begins business in a taxable year that ends after March 31, 1983, the original return and statement must be filed (and the election made) not later than the date prescribed by law for filing the return (including any extensions of time) for that taxable year. Once an election has been made, an amended return (or returns) and statement (or statements) may be filed to include any organizational expenses not included in the partnership's original return and statement.

[T.D. 7891, 48 FR 20048, May 4, 1983]

§ 1.709–2 Definitions.

(a) *Organizational expenses.* Section 709(b)(2) of the Internal Revenue Code defines organizational expenses as expenses which:

(1) Are incident to the creation of the partnership;

(2) Are chargeable to capital account; and

(3) Are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a)) be amortized over such life.

An expenditure which fails to meet one or more of these three tests does not qualify as an organizational expense for purposes of section 709(b) and this section. To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

(b) *Syndication expenses.* Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material. These expenses are not subject to the election under section 709(b) and must be capitalized.

(c) *Beginning business.* The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily, a partnership begins business when it starts the business operations for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business.

If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly, the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term *operating assets,* as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.

[T.D. 7891, 48 FR 20049, May 4, 1983]

CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS

CONTRIBUTIONS TO A PARTNERSHIP

§ 1.721–1 Nonrecognition of gain or loss on contribution.

(a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of § 1.731–1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and § 1.752–1.

(b)(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) Compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

(c) *Underwritings of partnership interests*—(1) *In general.* For the purpose of section 721, if a person acquires a partnership interest from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the partnership interest is treated as transferring cash directly to the partnership in exchange for the partnership interest and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a partnership issues partnership interests for cash in an underwriting in which either the underwriter is an agent of the partnership or the underwriter's ownership of the partnership interests is transitory.

(2) *Effective date.* This paragraph (c) is effective for qualified underwriting transactions occurring on or after May 1, 1996.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8665, 61 FR 19189, May 1, 1996]

§ 1.722–1 Basis of contributing partner's interest.

The basis to a partner of a partnership interest acquired by a contribution of property, including money, to the partnership shall be the amount of money contributed plus the adjusted basis at the time of contribution of any property contributed. If the acquisition of an interest in partnership capital results in taxable income to a partner, such income shall constitute an addition to the basis of the partner's interest. See paragraph (b) of § 1.721–1. If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, the basis of the contributing partner's interest shall be reduced by the portion of the indebtedness assumed by the other partners, since the partnership's assumption of his indebtedness is treated as a distribution of money to the partner. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them. See section 752 and § 1.752–1. The provisions of this section may be illustrated by the following examples:

Example 1. A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a fair market value of $10,000, an adjusted basis to A of $4,000, and was subject to a mortgage of $2,000. Payment of the mortgage was assumed by the partnership. The basis of A's interest in the partnership is $2,400, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $2,000)	1,600
Basis of A's interest	2,400

Example 2. If, in example 1 of this section, the property contributed by A was subject to a mortgage of $6,000, the basis of A's interest would be zero, computed as follows:

Adjusted basis to A of property contributed	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $6,000)	4,800
	(800)

Since A's basis cannot be less than zero, the $800 in excess of basis, which is considered as a distribution of money under section 752(b), is treated as capital gain from the sale or exchange or a partnership interest. See section 731(a).

§ 1.723–1 Basis of property contributed to partnership.

The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1223(2). For elective adjustments to the basis of partnership property arising from distributions or transfers of partnership interests, see sections 732(d), 734(b), and 743(b).

DISTRIBUTIONS BY A PARTNERSHIP

§ 1.731–1 Extent of recognition of gain or loss on distribution.

(a) *Recognition of gain or loss to partner*—(1) *Recognition of gain*. (i) Where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i.e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Thus, if a partner with a basis for his interest of $10,000 receives a distribution of cash of $8,000 and property with a fair market value of $3,000, no gain is recognized to him. If $11,000 cash were distributed, gain would be recognized to the extent of $1,000. No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items). See section 731(c) and paragraph (c) of this section.

(ii) For the purposes of sections 731 and 705, advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner.

(2) *Recognition of loss.* Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables (as defined in section 751(c)), and inventory items (as defined in section 751(d)(2)). The term *liquidation of a partner's interest*, as defined in section 761(d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions. Loss is recognized to the distributee partner in such cases to the extent of the excess of the adjusted basis of such partner's interest in the partnership at the time of the distribution over the sum of:

(i) Any money distributed to him, and

(ii) The basis to the distributee, as determined under section 732, of any unrealized receivables and inventory items that are distributed to him.

If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. Application of the provisions of this subparagraph may be illustrated by the following examples:

Example 1. Partner A has a partnership interest in partnership ABC with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $5,000 cash and inventory with a basis to him (under section 732) of $3,000. Partner A realizes a capital loss of $2,000, which is recognized under section 731(a)(2).

Example 2. Partner B has a partnership interest in partnership BCD with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of $2,000, and unrealized receivables having a basis to him (under section 732) of $3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is $3,000.

(3) *Character of gain or loss.* Gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

(b) *Gain or loss recognized by partnership.* A distribution of property (including money) by a partnership to a partner does not result in recognized gain or loss to the partnership under section 731. However, recognized gain or loss may result to the partnership from certain distributions which, under section 751(b), must be treated as a sale or exchange of property between the distributee partner and the partnership.

(c) *Exceptions.* (1) Section 731 does not apply to the extent otherwise provided by:

(i) Section 736 (relating to payments to a retiring partner or to a deceased partner's successor in interest) and

(ii) Section 751 (relating to unrealized receivables and inventory items).

For example, payments under section 736(a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section.

(2) The receipt by a partner from the partnership of money or property under an obligation to repay the amount of such money or to return such property does not constitute a distribution subject to section 731 but is a loan governed by section 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.

(3) If there is a contribution of property to a partnership and within a short period:

(i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

(ii) After such contribution the contributed property is distributed to another partner,

such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such transaction shall be treated as an exchange of property.

§ 1.731–2 Partnership distributions of marketable securities.

(a) *Marketable securities treated as money.* Except as otherwise provided in section 731(c) and this section, for purposes of sections 731(a)(1) and 737, the term money includes marketable securities and such securities are taken into account at their fair market value as of the date of the distribution.

(b) *Reduction of amount treated as money*—(1) *Aggregation of securities.* For purposes of section 731(c)(3)(B) and this paragraph (b), all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed security.

(2) *Amount of reduction.* The amount of the distribution of marketable securities that is treated as a distribution of money under section 731(c) and paragraph (a) of this section is reduced (but not below zero) by the excess, if any, of—

(i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

(3) *Distributee partner's share of net gain.* For purposes of section

731(c)(3)(B) and paragraph (b)(2) of this section, a partner's distributive share of net gain is determined—

(i) By taking into account any basis adjustments under section 743(b) with respect to that partner;

(ii) Without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c) and this section; and

(iii) Without taking into account any gain or loss attributable to a distributed security to which paragraph (d)(1) of this section applies.

(c) *Marketable securities*—(1) *In general.* For purposes of section 731(c) and this section, the term *marketable securities* is defined in section 731(c)(2).

(2) *Actively traded.* For purposes of section 731(c) and this section, a financial instrument is actively traded (and thus is a marketable security) if it is of a type that is, as of the date of distribution, actively traded within the meaning of section 1092(d)(1). Thus, for example, if *XYZ* common stock is listed on a national securities exchange, particular shares of *XYZ* common stock that are distributed by a partnership are marketable securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(3) *Interests in an entity*—(i) *Substantially all.* For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(ii) *Less than substantially all.* For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(4) *Value of assets.* For purposes of section 731(c) and this section, the value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c) and this section.

(d) *Exceptions*—(1) *In general.* Except as otherwise provided in paragraph (d)(2) of this section, section 731(c) and this section do not apply to the distribution of a marketable security if—

(i) The security was contributed to the partnership by the distributee partner;

(ii) The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are satisfied—

(A) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

(B) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

(iii) The security was not a marketable security on the date acquired by the partnership, and the following conditions are satisfied—

(A) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

(B) The security was held by the partnership for at least six months before the date the security became marketable; and

(C) The partnership distributed the security within five years of the date the security became marketable.

(2) *Anti-stuffing rule.* Paragraph (d)(1) of this section does not apply to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were originally contributed

to the partnership by the distributee partner). For purposes of this paragraph (d)(2), money contributed by the distributing partnership does not include any money deemed contributed by the partnership as a result of section 752.

(3) *Successor security*. Section 731(c) and this section apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) and this section otherwise would have applied to the exchanged security.

(e) *Investment partnerships*—(1) *In general.* Section 731(c) and this section do not apply to the distribution of marketable securities by an investment partnership (as defined in section 731(c)(3)(C)(i)) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

(2) *Eligible partner*—(i) *Contributed services.* For purposes of section 731(c)(3)(C)(iii) and this section, a partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership.

(ii) *Contributed partnership interests.* For purposes of determining whether a partner is an eligible partner under section 731(c)(3)(C), if the partner has contributed to the investment partnership an interest in another partnership that meets the requirements of paragraph (e)(4)(i) of this section after the contribution, the contributed interest is treated as property specified in section 731(c)(3)(C)(i).

(3) *Trade or business activities.* For purposes of section 731(c)(3)(C) and this section, a partnership is not treated as engaged in a trade or business by reason of——

(i) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;

(ii) Reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership (within the meaning of section 731(c)(3)(C)(i)) in which the partnership holds a partnership interest; or

(iii) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

(4) *Partnership tiers.* For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if——

(i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

(f) *Basis rules*—(1) *Partner's basis*—(i) *Partner's basis in distributed securities.* The distributee partner's basis in distributed marketable securities with respect to which gain is recognized by reason of section 731(c) and this section is the basis of the security determined under section 732, increased by the amount of such gain. Any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) and this section is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase.

(ii) *Partner's basis in partnership interest*. The basis of the distributee partner's interest in the partnership is determined under section 733 as if no gain were recognized by the partner on the distribution by reason of section 731(c) and this section.

(2) *Basis of partnership property*. No adjustment is made to the basis of partnership property under section 734 as a result of any gain recognized by a partner, or any step-up in the basis in the distributed marketable securities in the hands of the distributee partner, by reason of section 731(c) and this section.

(g) *Coordination with other sections*—(1) *Sections 704(c)(1)(B) and 737*—(i) *In general*. If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.

(ii) *Section 704(c)(1)(B)*. The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) includes the increase or decrease, if any, in the partner's basis that occurs under section 704(c)(1)(B)(iii) as a result of a distribution to another partner of property contributed by the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(iii) *Section 737*—(A) *Marketable securities as other property*. A distribution of marketable securities is treated as a distribution of property other than money for purposes of section 737 to the extent that the marketable securities are not treated as money under section 731(c). In addition, marketable securities contributed to the partnership are treated as property other than money in determining the contributing partner's net precontribution gain under section 737(b).

(B) *Basis increase under section 737*. The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) does not include the increase, if any, in the partner's basis that occurs under section 737(c)(1) as a result of a distribution of property to the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(2) *Section 708(b)(1)(B)*. If a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c) and this section. Accordingly, a section 708(b)(1)(B) termination will not affect whether a partnership qualifies for any of the exceptions in paragraphs (d) and (e) of this section. In addition, a deemed distribution that may occur as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c) and this section.

(h) *Anti-abuse rule*. The provisions of section 731(c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h)—

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and

the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, all securities held by a partnership are marketable securities within the meaning of section 731(c); the partnership holds no marketable securities other than the securities described in the example; all distributions by the partnership are subject to section 731(a) and are not subject to sections 704(c)(1)(B), 707(a)(2)(B), 751(b), or 737; and no securities are eligible for an exception to section 731(c). The examples are as follows:

Example 1. Recognition of gain. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes property with a fair market value of $1,000 and an adjusted tax basis of $250. *B* contributes $1,000 cash. *AB* subsequently purchases Security *X* for $500 and immediately distributes the security to *A* in a current distribution. The basis in *A*'s interest in the partnership at the time of distribution is $250.

(ii) The distribution of Security *X* is treated as a distribution of money in an amount equal to the fair market value of Security *X* on the date of distribution ($500). (The amount of the distribution that is treated as money is not reduced under section 731(c)(3)(B) and paragraph (b) of this section because, if Security *X* had been sold immediately before the distribution, there would have been no gain recognized by *AB* and *A*'s distributive share of the gain would therefore have been zero.) As a result, *A* recognizes $250 of gain under section 731(a)(1) on the distribution ($500 distribution of money less $250 adjusted tax basis in *A*'s partnership interest).

Example 2. Reduction in amount treated as money—in general. (i) *A* and *B* form partnership *AB* as equal partners. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X	100	70	30
Security Y	100	80	20
Security Z	100	110	(10)

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $40 of net gain ($30 gain on Security *X* plus $20 gain on Security *Y* minus $10 loss on Security *Z*). *A*'s distributive share of this gain would have been $20 (one-half of $40 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $10 of net gain ($20 of gain on Security *Y* minus $10 loss on Security *Z*). *A*'s distributive share of this gain would have been $5 (one-half of $10 net gain). As a result, the distribution resulted in a decrease of $15 in *A*'s distributive share of the net gain in *AB*'s securities ($20 net gain before distribution minus $5 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $15. The distribution of Security *X* is therefore treated as a distribution of $85 of money to *A* ($100 fair market value of Security *X* minus $15 reduction).

Example 3. Reduction in amount treated as money—carried interest. (i) *A* and *B* form partnership *AB*. *A* contributes $1,000 and provides substantial services to the partnership in exchange for a 60 percent interest in partnership profits. *B* contributes $1,000 in exchange for a 40 percent interest in partnership profits. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain:

	Value	Basis	Gain
Security *X*	100	80	20
Security *Y*	100	90	10

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $30 of net gain ($20 gain on Security *X* plus $10 gain on Security *Y*). *A*'s distributive share of this gain would have been $18 (60 percent of $30 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $10 of net gain ($10 gain on Security *Y*). *A*'s distributive share of this gain would have been $6 (60 percent of $10 net gain). As a result, the distribution resulted in a decrease of $12 in *A*'s distributive share of the net gain in *AB*'s securities ($18 net gain before distribution minus $6 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $12. The distribution of Security *X* is therefore treated as a distribution of $88 of money to *A* ($100 fair market value of Security *X* minus $12 reduction).

Example 4. Reduction in amount treated as money—change in partnership allocations. (i) *A* is admitted to partnership *ABC* as a partner with a 1 percent interest in partnership profits. At the time of *A*'s admission, *ABC* held no securities. *ABC* subsequently acquires Security *X*. *A*'s interest in partnership profits is subsequently increased to 2 percent for securities acquired after the increase. *A* retains a 1 percent interest in all securities acquired before the increase. *ABC* then acquires Securities *Y* and *Z* and later distributes Security *X* to *A* in a current distribution. Immediately before the distribution, the securities held by *ABC* had the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security *X*	1,000	500	500
Security *Y*	1,000	800	200
Security *Z*	1,000	1,100	(100)

(ii) If *ABC* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized $600 of net gain ($500 gain on Security *X* plus $200 gain on Security *Y* minus $100 loss on Security *Z*). *A*'s distributive share of this gain would have been $7 (1 percent of $500 gain on Security *X* plus 2 percent of $200 gain on Security *Y* minus 2 percent of $100 loss on Security *Z*).

(iii) If *ABC* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have $100 of net gain ($200 gain on Security *Y* minus $100 loss on Security *Z*). *A*'s distributive share of this gain would have been $2 (2 percent of $200 gain on Security *Y* minus 2 percent of $100 loss on Security *Z*). As a result, the distribution resulted in a decrease of $5 in *A*'s distributive share of the net gain in *ABC*'s securities ($7 net gain before distribution minus $2 net gain after distribution).

(iv) Under paragraph (b) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $5. The distribution of Security *X* is therefore treated as a distribution of $995 of money to *A* ($1000 fair market value of Security *X* minus $5 reduction).

Example 5. Basis consequences—distribution of marketable security. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property with a fair market value and adjusted tax basis of $100.

(ii) *AB* subsequently distributes Security *X* with a fair market value of $120 and an adjusted tax basis of $90 to *A* in a current distribution. At the time of distribution, the basis in *A*'s interest in the partnership is $100. The amount of the distribution that is treated as money is reduced under section 731(c)(3)(B) and paragraph (b)(2) of this section by $15 (one-half of $30 net gain in Security *X*). As a result, *A* recognizes $5 of gain under section 731(a) on the distribution (excess of $105 distribution of money over $100 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is $95 ($90 adjusted basis of Security *X* determined under section 732(a)(1) plus $5 of gain recognized by *A* by reason of section 731(c)). The basis in *A*'s interest in the partnership is $10 as determined under section 733 ($100 pre-distribution basis minus $90 basis allocated to Security *X* under section 732).

Example 6. Basis consequences—distribution of marketable security and other property. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes nondepreciable real property, with a fair market value of $100 and an adjusted tax basis of $10.

(ii) *AB* subsequently distributes Security *X* with a fair market value and adjusted tax basis of $40 to *A* in a current distribution and, as part of the same distribution, *AB* distributes Property *Z* to *A* with an adjusted tax basis and fair market value of $40. At the time of distribution, the basis in *A*'s interest in the partnership is $10. *A* recognizes $30 of gain under section 731(a) on the distribution (excess of $40 distribution of money over $10 adjusted tax basis in *A*'s partnership interest).

(iii) *A*'s adjusted tax basis in Security *X* is $35 ($5 adjusted basis determined under section 732(a)(2) plus $30 of gain recognized by *A* by reason of section 731(c)). *A*'s basis in Property *Z* is $5, as determined under section 732(a)(2). The basis in *A*'s interest in the partnership is $0 as determined under section 733 ($10 pre-distribution basis minus $10 basis allocated between Security *X* and Property *Z* under section 732).

(iv) *AB*'s adjusted tax basis in the remaining partnership assets is unchanged unless the partnership has a section 754 election in effect. If *AB* made such an election, the aggregate basis of *AB*'s assets would be increased by $70 (the difference between the $80 combined basis of Security *X* and Property *Z* in the hands of the partnership before the distribution and the $10 combined basis of the distributed property in the hands of *A* under section 732 after the distribution). Under section 731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by *A* by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of *A* by reason of section 731(c).

Example 7. Coordination with section 737. (i) *A* and *B* form partnership *AB*. *A* contributes Property *A*, nondepreciable real property with a fair market value of $200 and an adjusted basis of $100 in exchange for a 25 percent interest in partnership capital and profits. *AB* owns marketable Security *X*.

(ii) Within five years of the contribution of Property *A*, *AB* subsequently distributes Security *X*, with a fair market value of $120 and an adjusted tax basis of $100, to *A* in a current distribution that is subject to section 737. As part of the same distribution, *AB* distributes Property *Y* to *A* with a fair market value of $20 and an adjusted tax basis of $0. At the time of distribution, there has been no change in the fair market value of Property *A* or the adjusted tax basis in *A*'s interest in the partnership.

(iii) If *AB* had sold Security *X* for fair market value immediately before the distribution to *A*, the partnership would have recognized $20 of gain. *A*'s distributive share of this gain would have been $5 (25 percent of $20 gain). Because *AB* has no other marketable securities, *A*'s distributive share of gain in partnership securities after the distribution would have been $0. As a result, the distribution resulted in a decrease of $5 in *A*'s share of the net gain in *AB*'s securities ($5 net gain before distribution minus $0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security *X* that is treated as a distribution of money is reduced by $5. The distribution of Security *X* is therefore treated as a distribution of $115 of money to *A* ($120 fair market value of Security *X* minus $5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money ($5) is treated as other property for purposes of section 737.

(iv) *A* recognizes total gain of $40 on the distribution. *A* recognizes $15 of gain under section 731(a)(1) on the distribution of the portion of Security *X* treated as money ($115 distribution of money less $100 adjusted tax basis in *A*'s partnership interest). *A* recognizes $25 of gain under section 737 on the distribution of Property *Y* and the portion of Security *X* that is not treated as money. *A*'s section 737 gain is equal to the lesser of (i) *A*'s precontribution gain ($100) or (ii) the excess of the fair market value of property received ($20 fair market value of Property *Y* plus $5 portion of Security *X* not treated as money) over the adjusted basis in *A*'s interest in the partnership immediately before the distribution ($100) reduced (but not below zero) by the amount of money received in the distribution ($115).

(v) *A*'s adjusted tax basis in Security *X* is $115 ($100 basis of Security *X* determined under section 732(a) plus $15 of gain recognized by reason of section 731(c)). *A*'s adjusted tax basis in Property *Y* is $0 under section 732(a). The basis in *A*'s interest in the partnership is $25 ($100 basis before distribution minus $100 basis allocated to Security *X* under section 732(a) plus $25 gain recognized under section 737).

(k) *Effective date.* This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

[T.D. 8707, 61 FR 67938, Dec. 26, 1996; 62 FR 8086, Feb. 21, 1997]

§ 1.732–1 Basis of distributed property other than money.

(a) *Distributions other than in liquidation of a partner's interest.* The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Partner A, with an adjusted basis of $15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of $10,000 to the partnership immediately before distribution, and $2,000 cash. The basis of the property in A's hands will be $10,000. Under sections 733 and 705, the basis of A's partnership interest will be reduced by the distribution to $3,000 ($15,000 less $2,000 cash, less $10,000, the basis of the distributed property to A).

Example 2. Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

(b) *Distribution in liquidation.* Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

Example. Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

(c) *Allocation of basis among properties distributed to a partner*—(1) *General rule*—(i) *Unrealized receivables and inventory items.* The basis to be allocated to properties distributed to a partner under section 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and inventory items, the adjusted basis of the distributed property must be decreased in the manner provided in paragraph (c)(2)(i) of this section.

(ii) *Other distributed property.* Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution. However, if the sum of the adjusted bases to the partnership of such other distributed property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in paragraph (c)(2) of this section.

(2) *Adjustment to basis allocation*—(i) *Decrease in basis.* Any decrease to the basis of distributed property required under paragraph (c)(1) of this section is allocated first to distributed property with unrealized depreciation in proportion to each property's respective amount of unrealized depreciation before any decrease (but only to the extent of each property's unrealized depreciation). If the required decrease exceeds the amount of unrealized depreciation in the distributed property, the excess is allocated to the distributed property in proportion to the adjusted bases of the distributed property, as adjusted pursuant to the immediately preceding sentence.

(ii) *Increase in basis.* Any increase to the basis of distributed property required under paragraph (c)(1)(ii) of this section is allocated first to distributed property (other than unrealized receivables and inventory items) with unrealized appreciation in proportion to each property's respective amount of unrealized appreciation before any increase (but only to the extent of each property's unrealized appreciation). If the required increase exceeds the amount of unrealized appreciation in the distributed property, the excess is allocated to the distributed property (other than unrealized receivables or inventory items) in proportion to the fair market value of the distributed property.

(3) *Unrealized receivables and inventory items.* If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to the partner, and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of the partnership interest.

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

Example 1. A is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of $650. PRS distributes inventory items and Assets X and Y to A in liquidation of A's entire partnership interest. The distributed inventory items have a basis to the partnership of $100 and a fair market value of $200. Asset X has an adjusted basis to the partnership of $50 and a fair market value of $400. Asset Y has an adjusted basis to the partnership and a fair market value of $100. Neither Asset X nor Asset Y consists of inventory items or unrealized receivables. Under this paragraph (c), A's basis in its partnership interest is allocated first to the inventory items in an amount equal to their adjusted basis to the partnership. A, therefore, has an adjusted basis in the inventory items of $100. The remaining basis, $550, is allocated to the distributed property first in an amount equal to the property's adjusted basis to the partnership. Thus, Asset X is allocated $50 and Asset Y is allocated $100. Asset X is then allocated $350, the amount of unrealized appreciation in Asset X. Finally, the remaining basis, $50, is allocated to Assets X and Y in proportion to their fair market values: $40 to Asset X (400/500×$50), and $10 to Asset Y (100/500×$50). Therefore, after the distribution, A has an adjusted basis of $440 in Asset X and $110 in Asset Y.

Example 2. B is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of $200. PRS distributes Asset X and Asset Y to B in liquidation of its entire partnership interest. Asset X has an adjusted basis to the partnership and fair market value of $150. Asset Y has an adjusted basis to the partnership of $150 and a fair market value of $50. Neither of the assets consists of inventory items or unrealized receivables. Under this paragraph (c), B's basis is first assigned to the distributed property to the extent of the partnership's basis in each distributed property. Thus, Asset X and Asset Y are each assigned $150. Because the aggregate adjusted basis of the distributed property, $300, exceeds the basis to be allocated, $200, a decrease of $100 in the basis of the distributed property is required. Assets X and Y have unrealized depreciation of zero and $100, respectively. Thus, the entire decrease is allocated to Asset Y. After the distribution, B has an adjusted basis of $150 in Asset X and $50 in Asset Y.

Example 3. C, a partner in partnership PRS, receives a distribution in liquidation of its entire partnership interest of $6,000 cash, inventory items having an adjusted basis to the partnership of $6,000, and real property having an adjusted basis to the partnership of $4,000. C's basis in its partnership interest is $9,000. The cash distribution reduces C's basis to $3,000, which is allocated entirely to the inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

Example 4. Assume the same facts as in *Example 3* of this paragraph except C receives a distribution in liquidation of its entire partnership interest of $1,000 cash and inventory items having a basis to the partnership of $6,000. The cash distribution reduces C's basis to $8,000, which can be allocated only to the extent of $6,000 to the inventory items. The remaining $2,000 basis, not allocable to the distributed property, constitutes a capital loss to partner C under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(5) *Effective date.* This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999.

(d) *Special partnership basis to transferee under section 732(d).* (1)(i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and §§ 1.743–1 and 1.732–2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect.

(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed or by the partnership. (For a shift of transferee's basis adjustment under section 743(b) to like property, see § 1.743–1(g).)

(vi) The provisions of this paragraph (d)(1) may be illustrated by the following example:

Example. (i) Transferee partner, T, purchased a one-fourth interest in partnership PRS for $17,000. At the time T purchased the partnership interest, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a fair market value of $16,000. T's purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by T for the partnership interest was attributable to T's share of partnership inventory with a basis of $3,500. Within 2 years after T acquired the partnership interest, T retired from the partnership and received in liquidation of its entire partnership interest the following property:

	Assets	
	Adjusted basis to PRS	Fair market value
Cash	$1,500	$1,500
Inventory	3,500	4,000
Asset X	2,000	4,000
Asset Y	4,000	5,000

(ii) The fair market value of the inventory received by T was one-fourth of the fair market value of all partnership inventory and was T's share of such property. It is immaterial whether the inventory T received was on hand when T acquired the interest. In accordance with T's election under section 732(d), the amount of T's share of partnership basis that is attributable to partnership inventory is increased by $500 (one-fourth of the $2,000 difference between the fair market value of the property, $16,000, and its $14,000 basis to the partnership at the time T purchased its interest). This adjustment under section 732(d) applies only for purposes of distributions to T, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by T in the liquidating distribution is $15,500 ($17,000, T's basis for the partnership interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: the basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis, plus the basis adjustment of $500 which T would have had under section 743(b). The remaining basis of $11,500 ($15,500 minus $4,000) is allocated among the remaining property distributed to T by assigning to each property the adjusted basis to the partnership of such property and adjusting that basis by any required increase or decrease. Thus, the adjusted basis to T of Asset X is $5,111 ($2,000, the adjusted basis of Asset X to the partnership, plus $2,000, the amount of unrealized appreciation in Asset X, plus $1,111 ($4,000/$9,000 multiplied by $2,500)). Similarly, the adjusted basis of Asset Y to T is $6,389 ($4,000, the adjusted basis of Asset Y to the partnership, plus $1,000, the amount of unrealized appreciation in Asset Y, plus, $1,389 ($5,000/$9,000 multiplied by $2,500)).

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return:

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest:

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(ii) An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) A basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

(5) *Required statements.* If a transferee partner notifies a partnership that it plans to make the election under section 732(d) under paragraph (d)(3) of this section, or if a partnership makes a distribution to which paragraph (d)(4) of this section applies, the partnership must provide the transferee with such information as is necessary for the transferee properly to compute the transferee's basis adjustments under section 732(d).

(e) *Exception*. When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751(b). In such case, section 732 (including subsection(d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and paragraph (b) of § 1.751–1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69907, Dec. 15, 1999]

§ 1.732–2 Special partnership basis of distributed property.

(a) *Adjustments under section 734(b).* In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) *Adjustments under section 743(b).* In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

Example. Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743(b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of $1,000 and with respect to D it has a special basis adjustment of $500. Therefore, for purposes of section 732(a)(1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is $1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732(a)(1) is only $1,000. In such case, D's $500 special basis adjustment may shift over to other property. See §1.743–1(g).

(c) *Adjustments to basis of distributed inventory and unrealized receivables.* Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743(b) or section 732(d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all such items of the partnership. The provisions of this paragraph may be illustrated by the following example:

Example. Partner C acquired his 40-percent interest in partnership AC from a previous partner. Since the partnership had made an election under section 754, C has a special basis adjustment to partnership property under section 743(b). C retires from the partnership when the adjusted basis of his partnership interest is $3,000. He receives from the partnership in liquidation of his entire interest, $1,000 cash, certain capital assets, depreciable property, and certain inventory items and unrealized receivables. C has a special basis adjustment of $800 with respect to partnership inventory items and of $200 with respect to unrealized receivables. The common partnership basis for the inventory items distributed to him is $500 and for the unrealized receivables is zero. If the value of inventory items and the unrealized receivables distributed to C in his 40 percent share of the total value of all partnership inventory items and unrealized receivables, then, for purposes of section 732, the adjusted basis of such property in C's hands will be $1,300 for the inventory items ($500 plus $800) and $200 for the unrealized receivables (zero plus $200). The remaining basis of $500, which constitutes the basis of the capital assets and depreciable property distributed to C, is determined as follows: $3,000 (total basis) less $1,000 cash, or $2,000 (the amount to be allocated to the basis of all distributed property), less $1,500 ($800 and $200 special basis adjustments, plus $500 common partnership basis, the amount allocated to inventory items and unrealized receivables). However, if the value of the inventory items and unrealized receivables distributed to C consisted of only 20 percent of the total fair market value of such property (i. e., only one-half of C's 40-percent share), then only one-half of C's special basis adjustment of $800 for partnership inventory items and $200 for unrealized receivables would be taken into account. In that case, the basis of the inventory items in C's hands would be $650 ($250, the common partnership basis for inventory items distributed to him, plus $400, one-half of C's special basis adjustment for inventory items). The basis of the unrealized receivables in C's hands would be $100 (zero plus $100, one-half of C's special basis adjustment for unrealized receivables).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69908, Dec. 15, 1999]

§ 1.732–3 Corresponding adjustment to basis of assets of a distributed corporation controlled by a corporate partner.

The determination of whether a corporate partner has control of a distributed corporation for purposes of section 732(f) shall be made by applying the special aggregate stock ownership rules of § 1.1502–34.

[T.D. 8949, 66 FR 32902, June 19, 2001]

§ 1.733–1 Basis of distributee partner's interest.

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's entire interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner and by the amount of the basis to him of distributed property other than money as determined under section 732 and §§ 1.732–1 and 1.732–2.

§ 1.734–1 Optional adjustment to basis of undistributed partnership property.

(a) *General rule.* A partnership shall not adjust the basis of partnership property as the result of a distribution of property to a partner, unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect.

(b) *Method of adjustment*—(1) *Increase in basis.* Where an election under section 754 is in effect and a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the adjusted basis of the remaining partnership assets shall be increased by:

(i) The amount of any gain recognized under section 731(a)(1) to the distributee partner, or

(ii) The excess of the adjusted basis to the partnership immediately before the distribution of any property distributed (including adjustments under section 743(b) or section 732(d) when applied) over the basis under section 732 (including such special basis adjustments) of such property to the distributee partner.

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

Example 1. Partner A has a basis of $10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and a value of $22,000. A receives $11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of $1,000 under section 731(a)(1). If the election under section 754 is in effect, the partnership basis for the property becomes $20,000 ($19,000 plus $1,000).

Example 2. Partner D has a basis of $10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution shows the following:

ASSETS

	Adjusted basis	Value
Cash	$4,000	$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Total	30,000	33,000

LIABILITIES AND CAPITAL

	Adjusted basis	Value
Liabilities	$0	$0
Capital:		
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
Total	30,000	33,000

In liquidation of his entire interest in the partnership, D received property X with a partnership basis of $11,000. D's basis for property X is $10,000 under section 732(b). Where the election under section 754 is in effect, the excess of $1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes $16,000 ($15,000 plus $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734–2.

(2) *Decrease in basis.* Where the election provided in section 754 is in effect and a distribution is made in liquidation of a partner's entire interest, the partnership shall decrease the adjusted basis of the remaining partnership property by:

(i) The amount of loss, if any, recognized under section 731(a)(2) to the distributee partner, or

(ii) The excess of the basis of the distributed property to the distributee, as determined under section 732 (including adjustments under section 743(b) or section 732(d) when applied) over the adjusted basis of such property to the partnership (including such special basis adjustments) immediately before such distribution.

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

Example 1. Partner G has a basis of $11,000 for his one-third interest in partnership GHI. Partnership assets consist of cash of $10,000 and property with a basis of $23,000 and a value of $20,000. There are no partnership liabilities. In liquidation of his entire interest in the partnership, G receives $10,000 in cash. He has a loss of $1,000 under section 731(a)(2). If the election under section 754 is in effect, the partnership basis for the property becomes $22,000 ($23,000 less $1,000).

Example 2. Partner J has a basis of $11,000 for his one-third interest in partnership JKL. The partnership balance sheet before the distribution shows the following:

ASSETS

	Adjusted basis	Value
Cash	$5,000	$5,000
Property X	10,000	10,000
Property Y	18,000	15,000
Total	33,000	30,000

LIABILITIES AND CAPITAL

	Adjusted basis	Value
Liabilities	$0	$0
Capital:		
J	11,000	10,000
K	11,000	10,000
L	11,000	10,000
Total	33,000	30,000

In liquidation of his entire interest in the partnership, J receives property X with a partnership basis of $10,000. J's basis for property X under section 732(b) is $11,000. Where the election under section 754 is in effect, the excess of $1,000 ($11,000 basis of property X to J, the distributee, less its $10,000 adjusted basis to the partnership immediately before the distribution) decreases the basis of property Y in the partnership. Thus, the basis of property Y becomes $17,000 ($18,000 less $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734–2.

(c) *Allocation of basis.* For allocation among the partnership properties of basis adjustments under section 734(b) and paragraph (b) of this section, see section 755 and § 1.755–1.

(d) *Returns.* A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(e) *Recovery of adjustments to basis of partnership property*—(1) *Increases in basis.* For purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

(2) *Decreases in basis.* For purposes of section 168, if the basis of a partnership's recovery property is decreased as a result of the distribution of property to a partner, then the decrease in basis must be accounted for over the remaining recovery period of the property beginning with the recovery period in which the basis is decreased.

(3) *Effective date.* This paragraph (e) applies to distributions of property from a partnership that occur on or after December 15, 1999.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8847, 64 FR 69908, Dec. 15, 1999]

§ 1.734–2 Adjustment after distribution to transferee partner.

(a) In the case of a distribution of property by the partnership to a partner who has obtained all or part of his partnership interest by transfer, the adjustments to basis provided in section 743(b) and section 732(d) shall be taken into account in applying the rules under section 734(b). For determining the adjusted basis of distributed property to the partnership immediately before the distribution where there has been a prior transfer of a partnership interest with respect to which the election provided in section 754 or section 732(d) is in effect, see §§ 1.732–1 and 1.732–2.

(b)(1) If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:

Example. Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made the election under section 754 at the time of transfer, partner S had a special basis adjustment of $4,500 under section 743(b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is $10,000. S retires from the partnership and receives $10,000 in cash in exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of $4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to $5,500.

(2) The provisions of this paragraph do not apply to the extent that certain distributions are treated as sales or exchanges under section 751(b) (relating to unrealized receivables and substantially appreciated inventory items). See section 751(b) and paragraph (b) of § 1.751–1.

§ 1.735–1 Character of gain or loss on disposition of distributed property.

(a) *Sale or exchange of distributed property*—(1) *Unrealized receivables.* Any gain realized or loss sustained by a partner on a sale or exchange or other disposition of unrealized receivables (as defined in paragraph (c)(1) of § 1.751–1) received by him in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) *Inventory items.* Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in section 751(d)(2)) received in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset if such inventory items are sold or exchanged within 5 years from the date of the distribution by the partnership. The character of any gain or loss from a sale or exchange by the distributee partner of such inventory items after 5 years from the date of distribution shall be determined as of the date of such sale or exchange by reference to the character of the assets in his hands at that date (inventory items, capital assets, property used in a trade or business, etc.).

(b) *Holding period for distributed property.* A partner's holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735(a)(2) and paragraph (a)(2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223(2). For a partnership's holding period for contributed property, see § 1.723–1.

(c) *Effective date.* Section 735(a) applies to any property distributed by a partnership to a partner after March 9, 1954. See section 771(b)(2) and paragraph (b)(2) of § 1.771–1. However, see section 771(c).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

§ 1.736–1 Payments to a retiring partner or a deceased partner's successor in interest.

(a) *Payments considered as distributive share or guaranteed payment.* (1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of subchapter K, chapter 1 of the Code, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(b)), and (ii) other payments (section 736(a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See paragraph (b)(4)(ii) of §1.751–1. The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either:

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736(a)(1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to the extent considered as guaranteed payments under section 736(a)(2), are deductible by the partnership under section 162(a) and are taxable as ordinary income to the recipient under section 61(a). See section 707(c).

(5) The amount of any payments under section 736(a) shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment. On the other hand, payments under section 736(b) shall be taken into account by the recipient for his taxable year in which such payments are made. See paragraph (b)(4) of this section.

(6) A retiring partner or a deceased partner's successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives

payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708(b).

(b) *Payments for interest in partnership.* (1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner's interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736(a)). Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. If such valuation reflects only the partner's net interest in the property (i.e., total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. Gain or loss with respect to distributions under section 736(b) and this paragraph will be recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736(b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751(d), are subject to the rules provided in section 751(b) and paragraph (b) of § 1.751–1. The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the partnership has elected the optional basis adjustment under section 754. But see paragraph (b)(3)(iii) of § 1.751–1.

(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under section 736(b) from that portion treated as a distributive share or guaranteed payment under section 736(a). Such allocation shall be made as follows:

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736 (a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a) (1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount, $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736 (b) for 1956; $1,500, as a payment under section 736(a).

(ii) If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this subparagraph, the allocation of each annual payment between section 736 (a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under section 736(b) does not exceed the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751(b) applies, the amount of any gain or loss with respect to payments under section 736(b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under section 731. However, where the total of section 736(b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments), to report and to measure the amount of any gain or loss by the difference between:

(i) The amount treated as a distribution under section 736(b) in that year, and

(ii) The portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (i.e., the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under section 736(b) in that year bears to the total amount to be distributed under section 736(b)).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income.

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

Example 1. Partnership ABC is a personal service partnership and its balance sheet is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$13,000	$13,000
Unrealized receivables	0	30,000
Capital and section 1231 assets	20,000	23,000
Total	33,000	66,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$3,000	$3,000
Capital:		
A	10,000	21,000
B	10,000	21,000
C	10,000	21,000
Total	33,000	66,000

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736(b) partnership property is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and section 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A's interest is $11,000 ($10,000 plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is $10,000, consisting of $9,000 in cash, plus $1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a section 736(a)(2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in section 736(b) partnership property. (The partnership may deduct the $6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A's interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is a return of capital.

Example 2. Assume the same facts as in example 1 of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to $12,000 shall be treated under section 736(b) as payments for A's interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under section 736(a)(1).

Example 3. Assume the same facts as in example 1 of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to be $9,000. The value of A's interest in partnership property described in section 736(b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash, plus $23,000, the value of capital and section 1231 assets, plus $9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000, minus $11,000) the basis of his interest. The remaining $15,000 ($30,000 minus $15,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

Example 4. Assume the same facts as in example 1 of this subparagraph except that the capital and section 1231 assets consist of an item of section 1245 property (as defined in section 1245(a)(3)). Assume further that under paragraph (c)(4) of §1.751–1 the section 1245 property is an unrealized receivable to the extent of $2,000. Therefore, the value of A's interest in section 736(b) partnership property is only $11,333 (one-third of $34,000, the sum of $13,000 cash and $21,000, the fair market value of section 1245 property to the extent not an unrealized receivable). From the disposition of his interest in partnership property, A will realize a capital gain of $333 ($11,333 minus $11,000, the basis of his interest). The remaining $18,667 ($30,000 minus $11,333) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

(c) *Cross reference.* See section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

§ 1.737–1 Recognition of precontribution gain.

(a) *Determination of gain*—(1) *In general.* A partner that receives a distribution of property (other than money) must recognize gain under section 737 and this section in an amount equal to the lesser of the excess distribution (as defined in paragraph (b) of this section) or the partner's net precontribution gain (as defined in paragraph (c) of this section). Gain recognized under section 737 and this section is in addition to any gain recognized under section 731.

(2) *Transactions to which section 737 applies.* Section 737 and this section apply only to the extent that a distribution by a partnership is a distribution to a partner acting in the capacity of a partner within the meaning of section 731, except that section 737 and this section do not apply to the extent

that section 751(b) applies to the distribution.

(b) *Excess distribution*—(1) *Definition*. The excess distribution is the amount (if any) by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted tax basis in the partner's partnership interest.

(2) *Fair market value of property*. The fair market value of the distributed property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(3) *Distributee partner's adjusted tax basis*—(i) *General rule*. In determining the amount of the excess distribution, the distributee partner's adjusted tax basis in the partnership interest includes any basis adjustment resulting from the distribution that is subject to section 737 (for example, adjustments required under section 752) and from any other distribution or transaction that is part of the same distribution, except for—

(A) The increase required under section 737(c)(1) for the gain recognized by the partner under section 737; and

(B) The decrease required under section 733(2) for any property distributed to the partner other than property previously contributed to the partnership by the distributee partner. See §1.704–4(e)(1) for a rule in the context of section 704(c)(1)(B). See also §1.737–3(b)(2) for a special rule for determining a partner's adjusted tax basis in distributed property previously contributed by the partner to the partnership.

(ii) *Advances or drawings*. The distributee partner's adjusted tax basis in the partnership interest is determined as of the last day of the partnership's taxable year if the distribution to which section 737 applies is properly characterized as an advance or drawing against the partner's distributive share of income. See §1.731–1(a)(1)(ii).

(c) *Net precontribution gain*—(1) *General rule*. The distributee partner's net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) and §1.704–4 if all property that had been contributed to the partnership by the distributee partner within five years of the distribution and is held by the partnership immediately before the distribution had been distributed by the partnership to another partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. See §1.704–4 for provisions determining a contributing partner's gain or loss under section 704(c)(1)(B) on an actual distribution of contributed section 704(c) property to another partner.

(2) *Special rules*—(i) *Property contributed on or before October 3, 1989*. Property contributed to the partnership on or before October 3, 1989, is not taken into account in determining a partner's net precontribution gain. See §1.704–4(c)(1) for a similar rule in the context of section 704(c)(1)(B).

(ii) *Section 734(b)(1)(A) adjustments*. For distributions to a distributee partner of money by a partnership with a section 754 election in effect that are part of the same distribution as the distribution of property subject to section 737, for purposes of paragraph (a) and (c)(1) of this section the distributee partner's net precontribution gain is reduced by the basis adjustments (if any) made to section 704(c) property contributed by the distributee partner under section 734(b)(1)(A). See §1.737–3(c)(4) for rules regarding basis adjustments for partnerships with a section 754 election in effect.

(iii) *Transfers of a partnership interest*. The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred. See §1.704–3(a)(7) and §1.704–4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

(iv) *Section 704(c)(1)(B) gain recognized in related distribution*. A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and § 1.704–4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and § 1.704–4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.

(v) *Section 704(c)(2) disregarded.* A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and § 1.704–4(d)(3) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

(d) *Character of gain.* The character of the gain recognized by the distributee partner under section 737 and this section is determined by, and is proportionate to, the character of the partner's net precontribution gain. For this purpose, all gains and losses on section 704(c) property taken into account in determining the partner's net precontribution gain are netted according to their character. Character is determined at the partnership level for this purpose, and any character with a net negative amount is disregarded. The character of the partner's gain under section 737 is the same as, and in proportion to, any character with a net positive amount. Character for this purpose is determined as if the section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution and includes any item that would have been taken into account separately by the contributing partner under section 702(a) and § 1.702–1(a).

(e) *Examples.* The following examples illustrate the provisions of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Calculation of excess distribution and net precontribution gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable real property with a fair market value of $30,000 and an adjusted tax basis of $20,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $30,000. C contributes $30,000 cash.

(ii) Property A has 10 years remaining on its cost recovery schedule and is depreciated using the straight-line method. The partnership uses the traditional method for allocating items under section 704(c) described in § 1.704–3(b)(1) for Property A. The partnership has book depreciation of $3,000 per year (10 percent of the $30,000 book basis in Property A) and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000). The partnership also has tax depreciation of $2,000 per year (10 percent of the $20,000 adjusted tax basis in Property A). This $2,000 tax depreciation is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of 1997, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and its adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation).

(iv) On December 31, 1997, Property B is distributed to A in complete liquidation of A's partnership interest. The adjusted tax basis of A's partnership interest at that time is $20,000. The amount of the excess distribution is $10,000, the difference between the fair market value of the distributed Property B ($30,000) and A's adjusted tax basis in A's partnership interest ($20,000). A's net precontribution gain is $7,000, the difference between the book value of Property A ($21,000) and its adjusted tax basis at the time of the distribution ($14,000). A recognizes gain of $7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Determination of distributee partner's basis. (i) On January 1, 1995, A, B, and C form general partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. B and C each contributes $10,000 cash.

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of $9,000, subject to a $9,000 nonrecourse liability. This nonrecourse liability is allocated equally among the partners under section 752, increasing A's adjusted tax basis in A's partnership interest from $4,000 to $7,000.

(iii) On December 31, 1998, A receives $2,000 cash and Property B, subject to the $9,000 liability, in a current distribution.

(iv) In determining the amount of the excess distribution, the adjusted tax basis of A's partnership interest is adjusted to take into account the distribution of money and the shift in liabilities. A's adjusted tax basis is therefore increased to $11,000 for this purpose ($7,000 initial adjusted tax basis, less $2,000 distribution of money, less $3,000 (decrease in A's share of the $9,000 partnership liability), plus $9,000 (increase in A's individual liabilities)). As a result of this basis adjustment, the adjusted tax basis of A's partnership interest ($11,000) is greater than the fair market value of the distributed property ($9,000) and therefore, there is no excess distribution. A recognizes no gain under section 737.

Example 3. Net precontribution gain reduced for gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Properties A1 and A2, nondepreciable real properties located in the United States each with a fair market value of $10,000 and an adjusted tax basis of $6,000. B contributes Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of $20,000. C contributes $20,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest and, as part of the same distribution, Property A1 is distributed to B in a current distribution.

(iii) A's net precontribution gain before the distribution is $8,000 ($20,000 fair market value of Properties A1 and A2 less $12,000 adjusted tax basis of such properties). A recognizes $4,000 of gain under section 704(c)(1)(B) and § 1.704–4 on the distribution of Property A1 to B ($10,000 fair market value of Property A1 less $6,000 adjusted tax basis of Property A1). This gain is taken into account in determining A's excess distribution and net precontribution gain. As a result, A's net precontribution gain is reduced from $8,000 to $4,000, and the adjusted tax basis in A's partnership interest is increased by $4,000 to $16,000.

(iv) A recognizes gain of $4,000 on the receipt of Property B under section 737, an amount equal to the lesser of the excess distribution of $4,000 ($20,000 fair market value of Property B less $16,000 adjusted tax basis of A's interest in the partnership) and A's remaining net precontribution gain of $4,000.

Example 4. Character of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$30,000	$20,000
Property A2	30,000	38,000
Property A3	10,000	9,000

(ii) The character of gain or loss on Property A1 and Property A2 is long-term, U.S.-source capital gain or loss. The character of gain on Property A3 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $70,000. C contributes $70,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes $3,000 of gain under section 737, an amount equal to the excess distribution of $3,000 ($70,000 fair market value of Property B less $67,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $3,000 ($70,000 aggregate fair market value of properties contributed by A less $67,000 aggregate adjusted tax basis of such properties).

(iv) In determining the character of A's gain, all gains and losses on property taken into account in determining A's net precontribution gain are netted according to their character and allocated to A's recognized gain under section 737 based on the relative proportions of the net positive amounts. U.S.-source and foreign-source gains must be netted separately because A would have been required to take such gains into account separately under section 702. As a result, A's net precontribution gain of $3,000 consists of $2,000 of net long-term, U.S.-source capital gain ($10,000 gain on Property A1 and $8,000 loss on Property A2) and $1,000 of net long-term, foreign-source capital gain ($1,000 gain on Property A3).

(v) The character of A's gain under paragraph (d) of this section is therefore $2,000 long-term, U.S.-source capital gain ($3,000 gain recognized under section 737×$2,000 net long-term, U.S.-source capital gain/$3,000 total net precontribution gain) and $1,000 long-term, foreign-source capital gain ($3,000 gain recognized under section 737 × $1,000 net long-term, foreign-source capital gain/$3,000 total net precontribution gain).

[T.D. 8642, 60 FR 66733, Dec. 26, 1995]

§ 1.737–2 Exceptions and special rules.

(a) *Section 708(b)(1)(B) terminations.* Section 737 and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of property by the new partnership to a partner of the new partnership that was formerly a partner of the terminated partnership is subject to section 737 to the same extent that a distribution from the terminated partnership would have been subject to section 737. See also § 1.704–4(c)(3) for a similar rule in the context of section 704(c)(1)(B). This paragraph (a) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a) to the termination in a consistent manner.

(b) *Transfers to another partnership*—(1) *Complete transfer.* Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. See §1.704–4(c)(4) for a similar rule in the context of section 704(c)(1)(B).

(2) *Certain divisive transactions.* Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of the section 704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the section 704(c) property to the transferor partnership.

(3) *Subsequent distributions.* A subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

(c) *Incorporation of a partnership.* Section 737 and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See §1.704–4(c)(5) for a similar rule in the context of section 704(c)(1)(B).

(d) *Distribution of previously contributed property*—(1) *General rule.* Any portion of the distributed property that consists of property previously contributed by the distributee partner (previously contributed property) is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. The previous sentence applies on or after May 9, 1997. See §1.737–3(b)(2) for a special rule for determining the basis of previously contributed property in the hands of a distributee partner who contributed the property to the partnership.

(2) *Limitation for distribution of previously contributed interest in an entity.* An interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent that the value of the interest is attributable to property contributed to the entity after the interest was contributed to the partnership. The preceding sentence does not apply to the extent that the property contributed to the entity was contributed to the partnership by the partner that also contributed the interest in the entity to the partnership.

(3) *Nonrecognition transactions.* Property received by the partnership in exchange for contributed section 704(c) property in a nonrecognition transaction is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the property received is treated as section 704(c) property under §1.704–3(a)(8). See §1.704–4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(4) *Undivided interests.* The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. See §1.704–4(c)(6) for the application of section 704(c)(1)(B) in a similar context. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is

treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(e) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Distribution of previously contributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$20,000	$10,000
Property A2	10,000	6,000

(ii) A's total net precontribution gain on the contributed property is $14,000 ($10,000 on Property A1 plus $4,000 on Property A2). B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $20,000. C contributes $30,000 cash.

(iii) On December 31, 1998, Property A2 and Property B are distributed to A in complete liquidation of A's interest in the partnership. Property A2 was previously contributed by A and is therefore not taken into account in determining the amount of the excess distribution or A's net precontribution gain. The adjusted tax basis of Property A2 in the hands of A is also determined under section 732 as if that property were the only property distributed to A.

(iv) As a result of excluding Property A2 from these determinations, the amount of the excess distribution is $10,000 ($20,000 fair market value of distributed Property B less $10,000 adjusted tax basis in A's partnership interest). A's net precontribution gain is also $10,000 ($14,000 total net precontribution gain less $4,000 gain with respect to previously contributed Property A2). A therefore recognizes $10,000 of gain on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Distribution of a previously contributed interest in an entity. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000, and all of the stock of Corporation X with a fair market value and adjusted tax basis of $500. B contributes $500 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. Partner C contributes $10,500 cash. On December 31, 1996, ABC contributes Property B to Corporation X in a nonrecognition transaction under section 351.

(ii) On December 31, 1998, all of the stock of Corporation X is distributed to A in complete liquidation of A's interest in the partnership. The stock is treated as previously contributed property with respect to A only to the extent of the $500 fair market value of the Corporation X stock contributed by A. The fair market value of the distributed stock for purposes of determining the amount of the excess distribution is therefore $10,000 ($10,500 total fair market value of Corporation X stock less $500 portion treated as previously contributed property). The $500 fair market value and adjusted tax basis of the Corporation X stock is also not taken into account in determining the amount of the excess distribution and the net precontribution gain.

(iii) A recognizes $5,000 of gain under section 737, the amount of the excess distribution ($10,000 fair market value of distributed property less $5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain ($10,000 fair market value of Property A less $5,000 adjusted tax basis in Property A).

Example 3. Distribution of undivided interest in property. (i) On January 1, 1995, A and B form partnership AB as equal partners. A contributes $500 cash and an undivided one-half interest in Property X. B contributes $500 cash and an undivided one-half interest in Property X.

(ii) On December 31, 1998, an undivided one-half interest in Property X is distributed to A in a current distribution. The distribution of the undivided one-half interest in Property X is treated as a distribution of previously contributed property because A contributed an undivided one-half interest in Property X. As a result, A does not recognize any gain under section 737 on the distribution.

[T.D. 8642, 60 FR 66735, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25501, May 9, 1997]

§ 1.737–3 Basis adjustments; Recovery rules.

(a) *Distributee partner's adjusted tax basis in the partnership interest.* The distributee partner's adjusted tax basis in the partnership interest is increased by the amount of gain recognized by the distributee partner under section 737 and this section. This increase is not taken into account in determining the amount of gain recognized by the partner under section 737(a)(1) and this section or in determining the amount of gain recognized by the partner under section 731(a) on the distribution of money in the same distribution or any related distribution. See § 1.704–4(e)(1) for a determination of the distributee partner's adjusted tax basis in a distribution subject to section 704(c)(1)(B).

(b) *Distributee partner's adjusted tax basis in distributed property*—(1) *In general.* The distributee partner's adjusted tax basis in the distributed property is determined under section 732 (a) or (b) as applicable. The increase in the distributee partner's adjusted tax basis in the partnership interest under paragraph (a) of this section is taken into account in determining the distributee partner's adjusted tax basis in the distributed property other than property previously contributed by the partner. See § 1.704–4(e)(2) for a determination of basis in a distribution subject to section 704(c)(1)(B).

(2) *Previously contributed property.* The distributee partner's adjusted tax basis in distributed property that the partner previously contributed to the partnership is determined as if it were distributed in a separate and independent distribution prior to the distribution that is subject to section 737 and § 1.737–1.

(c) *Partnership's adjusted tax basis in partnership property*—(1) *Increase in basis.* The partnership's adjusted tax basis in eligible property is increased by the amount of gain recognized by the distributee partner under section 737.

(2) *Eligible property.* Eligible property is property that——

(i) Entered into the calculation of the distributee partner's net precontribution gain;

(ii) Has an adjusted tax basis to the partnership less than the property's fair market value at the time of the distribution;

(iii) Would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under section 737; and

(iv) Was not distributed to another partner in a distribution subject to section 704(c)(1)(B) and § 1.704–4 that was part of the same distribution as the distribution subject to section 737.

(3) *Method of adjustment.* For the purpose of allocating the basis increase under paragraph (c)(2) of this section among the eligible property, all eligible property of the same character is treated as a single group. Character for this purpose is determined in the same manner as the character of the recognized gain is determined under § 1.737–1(d). The basis increase is allocated among the separate groups of eligible property in proportion to the character of the gain recognized under section 737. The basis increase is then allocated among property within each group in the order in which the property was contributed to the partnership by the partner, starting with the property contributed first, in an amount equal to the difference between the property's fair market value and its adjusted tax basis to the partnership at the time of the distribution. For property that has the same character and was contributed in the same (or a related) transaction, the basis increase is allocated based on the respective amounts of unrealized appreciation in such properties at the time of the distribution.

(4) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (c)(1) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including eligible property as defined in paragraph (c)(2) of this section) under section 734(b) pursuant to a section 754 election (other than basis adjustments under section 734(b)(1)(A) described in the following sentence) must be made after (and must take into account) the adjustments to basis made under paragraph (a) and paragraph (c)(1) of this section. Basis adjustments under section 734(b)(1)(A) that are attributable to distributions of money to the distributee partner that are part of the same distribution as the distribution of property subject to section 737 are made before the adjustments to basis under paragraph (a) and paragraph (c)(1) of this section. See § 1.737–1(c)(2)(ii) for the effect, if any, of basis

adjustments under section 734(b)(1)(A) on a partner's net precontribution gain. See also § 1.704–4(e)(3) for a similar rule regarding basis adjustments pursuant to a section 754 election in the context of section 704(c)(1)(B).

(d) *Recovery of increase to adjusted tax basis.* Any increase to the adjusted tax basis of partnership property under paragraph (c)(1) of this section is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

(e) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Partner's basis in distributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $10,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes $5,000 of gain under section 737, an amount equal to the excess distribution of $5,000 ($10,000 fair market value of Property B less $5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $5,000 ($10,000 fair market value of Property A less $5,000 adjusted tax basis of such property).

(iii) A's adjusted tax basis in A's partnership interest is increased by the $5,000 of gain recognized under section 737. This increase is taken into account in determining A's basis in the distributed property. Therefore, A's adjusted tax basis in distributed Property B is $10,000 under section 732(b).

Example 2. Partner's basis in distributed property in connection with gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property located in the United States to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$10,000	5,000
Property A2	10,000	2,000

(ii) B contributes $10,000 cash and Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of $10,000. C contributes $20,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in a current distribution and Property A1 is distributed to B in a current distribution. A recognizes $5,000 of gain under section 704(c)(1)(B) and § 1.704–4 on the distribution of Property A1 to B, the difference between the fair market value of such property ($10,000) and the adjusted tax basis in distributed Property A1 ($5,000). The adjusted tax basis of A's partnership interest is increased by this $5,000 of gain under section 704(c)(1)(B) and § 1.704–4(e)(1).

(iv) The increase in the adjusted tax basis of A's partnership interest is taken into account in determining the amount of the excess distribution. As a result, there is no excess distribution because the fair market value of Property B ($10,000) is less than the adjusted tax basis of A's interest in the partnership at the time of distribution ($12,000). A therefore recognizes no gain under section 737 on the receipt of Property B. A's adjusted tax basis in Property B is $10,000 under section 732(a)(1). The adjusted tax basis of A's partnership interest is reduced from $12,000 to $2,000 under section 733. See *Example 3* of § 1.737–1(e).

Example 3. Partnership's basis in partnership property after a distribution with section 737 gain. (i) On January 31, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	$1,000	$500
Property A2	4,000	1,500
Property A3	4,000	6,000
Property A4	6,000	4,000

(ii) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-source capital gain or loss. The character of gain on Property A4 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $15,000. C contributes $15,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes gain of $3,000 under section 737, an amount equal to the excess distribution of $3,000 ($15,000 fair market value of Property B less $12,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $3,000 ($15,000 aggregate fair market value of the property contributed by A less $12,000 aggregate adjusted tax basis of such property).

(iv) $2,000 of A's gain is long-term, foreign-source capital gain ($3,000 total gain under section 737 × $2,000 net long-term, foreign-source capital gain/$3,000 total net precontribution gain). $1,000 of A's gain is long-term, U.S.-source capital gain ($3,000 total gain under section 737 × $1,000 net long-term, U.S.-source capital gain/$3,000 total net precontribution gain).

(v) The partnership must increase the adjusted tax basis of the property contributed by A by $3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(vi) $2,000 of the basis increase must be allocated to long-term, foreign-source capital assets because $2,000 of the gain recognized by A was long-term, foreign-source capital gain. The adjusted tax basis of Property A4 is therefore increased from $4,000 to $6,000. $1,000 of the increase must be allocated to Properties A1 and A2 because $1,000 of the gain recognized by A is long-term, U.S.-source capital gain. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax basis. The $1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by $167 ($1,000×$500/$3,000) and the adjusted tax basis of Property A2 is increased by $833 ($1,000×$2,500/3,000).

[T.D. 8642, 60 FR 66736, Dec. 26, 1995; 61 FR 7214, Feb. 27, 1996]

§ 1.737–4 Anti-abuse rule.

(a) *In general.* The rules of section 737 and §§ 1.737–1, 1.737–2, and 1.737–3 must be applied in a manner consistent with the purpose of section 737. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 737. Whether a tax result is inconsistent with the purpose of section 737 must be determined based on all the facts and circumstances. See § 1.704–4(f) for an anti-abuse rule and examples in the context of section 704(c)(1)(B). The anti-abuse rule and examples under section 704(c)(1)(B) and § 1.704–4(f) are relevant to section 737 and §§ 1.737–1, 1.737–2, and 1.737–3 to the extent that the net precontribution gain for purposes of section 737 is determined by reference to section 704(c)(1)(B).

(b) *Examples.* The following examples illustrate the rules of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Increase in distributee partner's basis by temporary contribution; results inconsistent with the purpose of section 737. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B contributes Property B, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $10,000. C contributes $10,000 cash.

(ii) On January 1, 1999, pursuant to a plan a principal purpose of which is to avoid gain under section 737, A transfers to the partnership Property A2, nondepreciable real property with a fair market value and adjusted tax basis of $9,000. A treats the transfer as a contribution to the partnership pursuant to section 721 and increases the adjusted tax basis of A's partnership interest from $1,000 to $10,000. On January 1, 1999, the partnership agreement is amended and all other necessary steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A. On February 1, 1999, Property B is distributed to A in a current distribution. If the contribution of Property A2 is treated as a contribution to the partnership for purposes of section 737, there is no excess distribution because the fair market value of distributed Property B ($10,000) does not exceed the adjusted tax basis of A's interest in the partnership ($10,000), and therefore section 737 does not apply. A's adjusted tax basis in distributed Property B is $10,000 under section 732(a)(1) and the adjusted tax basis of A's partnership interest is reduced to zero under section 733.

(iii) On March 1, 2000, A receives Property A2 from the partnership in complete liquidation of A's interest in the partnership. A recognizes no gain on the distribution of Property A2 because the property was previously contributed property. See § 1.737–2(d).

(iv) Although A has treated the transfer of Property A2 as a contribution to the partnership that increased the adjusted tax basis of A's interest in the partnership, it would be inconsistent with the purpose of section 737 to recognize the transfer as a contribution to the partnership. Section 737 requires recognition of gain when the value of distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. Section 737 assumes that any contribution or other transaction that affects a partner's adjusted tax basis in the partnership interest is a contribution or transaction in substance and is not engaged in with a principal purpose of avoiding recognition of gain under section 737. Because the transfer of Property A2 to the partnership was not a contribution in substance and was made with a principal purpose of avoiding recognition of gain under section 737, the Commissioner can disregard the contribution of Property A2 for this purpose. As a result, A recognizes gain of $9,000 under section 737 on the receipt of Property B, an amount equal to the lesser of the excess distribution of $9,000 ($10,000 fair market value of distributed Property B less the $1,000 adjusted tax basis of A's partnership interest, determined without regard to the transitory contribution of Property A2) or A's net precontribution gain of $9,000 on Property A1.

Example 2. Increase in distributee partner's basis; section 752 liability shift; results consistent with the purpose of section 737. (i) On January 1, 1995, A and B form general partnership AB as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. The partnership also borrows $10,000 on a recourse basis and purchases Property C. The $10,000 liability is allocated equally between A and B under section 752, thereby increasing the adjusted tax basis in A's partnership interest to $6,000.

(ii) On December 31, 1998, the partners agree that A is to receive Property B in a current distribution. If A were to receive Property B at that time, A would recognize $4,000 of gain under section 737, an amount equal to the lesser of the excess distribution of $4,000 ($10,000 fair market value of Property B less $6,000 adjusted tax basis in A's partnership interest) or A's net precontribution gain of $9,000 ($10,000 fair market value of Property A less $1,000 adjusted tax basis of Property A).

(iii) With a principal purpose of avoiding such gain, A and B agree that A will be solely liable for the repayment of the $10,000 partnership liability and take the steps necessary so that the entire amount of the liability is allocated to A under section 752. The adjusted tax basis in A's partnership interest is thereby increased from $6,000 to $11,000 to reflect A's share of the $5,000 of liability previously allocated to B. As a result of this increase in A's adjusted tax basis, there is no excess distribution because the fair market value of distributed Property B ($10,000) is less than the adjusted tax basis of A's partnership interest. Recognizing A's increased adjusted tax basis as a result of the shift in liabilities is consistent with the purpose of section 737 and this section. Section 737 requires recognition of gain only when the value of the distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. The $10,000 recourse liability is a bona fide liability of the partnership that was undertaken for a substantial business purpose and A's and B's agreement that A will assume responsibility for repayment of that debt has substance. Therefore, the increase in A's adjusted tax basis in A's interest in the partnership due to the shift in partnership liabilities under section 752 is respected, and A recognizes no gain under section 737.

[T.D. 8642, 60 FR 66738, Dec. 26, 1995]

§ 1.737–5 Effective date.

Sections 1.737–1, 1.737–2, 1.737–3, and 1.737–4 apply to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66739, Dec. 26, 1995]

TRANSFERS OF INTERESTS IN A PARTNERSHIP

§ 1.741–1 Recognition and character of gain or loss on sale or exchange.

(a) The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705. For treatment of selling partner's distributive share up to date of sale, see section 706(c)(2). Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items. See section 751 and § 1.751–1.

(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. Section 741 shall also apply even though the sale of the partnership interest results in a termination of the partnership under section 708(b). Thus, the provisions of section 741 shall be applicable (1) to the transferor partner in a 2-man partnership when he sells his interest to the other partner, and (2) to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

(c) See section 351 for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferor.

(d) For rules relating to the treatment of liabilities on the sale or exchange of interests in a partnership see §§ 1.752–1 and 1.1001–2.

(e) For rules relating to the capital gain or loss recognized when a partner sells or exchanges an interest in a partnership that holds appreciated collectibles or section 1250 property with section 1250 capital gain, see § 1.1(h)–1. This paragraph (e) applies to transfers of interests in partnerships that occur on or after September 21, 2000.

(f) For rules relating to dividing the holding period of an interest in a partnership, see § 1.1223–3. This paragraph (f) applies to transfers of partnership interests and distributions of property from a partnership that occur on or after September 21, 2000.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980; T.D. 8902, 65 FR 57099, Sept. 21, 2000]

§ 1.742–1 Basis of transferee partner's interest.

The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), subchapter O, chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706–1 and paragraph (b) of § 1.753–1) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

§ 1.743–1 Optional adjustment to basis of partnership property.

(a) *Generally*. The basis of partnership property is adjusted as a result of the transfer of an interest in a partnership by sale or exchange or on the death of a partner only if the election provided by section 754 (relating to optional adjustments to the basis of partnership property) is in effect with respect to the partnership. Whether or not the election provided in section 754 is in effect, the basis of partnership property is not adjusted as the result of a contribution of property, including money, to the partnership.

(b) *Determination of adjustment*. In the case of the transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership that has an election under section 754 in effect—

(1) Increases the adjusted basis of partnership property by the excess of the transferee's basis for the transferred partnership interest over the transferee's share of the adjusted basis to the partnership of the partnership's property; or

(2) Decreases the adjusted basis of partnership property by the excess of the transferee's share of the adjusted

basis to the partnership of the partnership's property over the transferee's basis for the transferred partnership interest.

(c) *Determination of transferee's basis in the transferred partnership interest.* In the case of the transfer of a partnership interest by sale or exchange or as a result of the death of a partner, the transferee's basis in the transferred partnership interest is determined under section 742 and § 1.742–1. See also section 752 and §§ 1.752–1 through 1.752–5.

(d) *Determination of transferee's share of the adjusted basis to the partnership of the partnership's property*—(1) *Generally.* A transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. Generally, a transferee's interest as a partner in the partnership's previously taxed capital is equal to—

(i) The amount of cash that the transferee would receive on a liquidation of the partnership following the hypothetical transaction, as defined in paragraph (d)(2) of this section (to the extent attributable to the acquired partnership interest); increased by

(ii) The amount of tax loss (including any remedial allocations under § 1.704–3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest); and decreased by

(iii) The amount of tax gain (including any remedial allocations under § 1.704–3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest).

(2) *Hypothetical transaction defined.* For purposes of paragraph (d)(1) of this section, the hypothetical transaction means the disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets.

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

Example 1. (i) A is a member of partnership PRS in which the partners have equal interests in capital and profits. The partnership has made an election under section 754, relating to the optional adjustment to the basis of partnership property. A sells its interest to T for $22,000. The balance sheet of the partnership at the date of sale shows the following:

	Assets	
	Adjusted basis	Fair market value
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000
Total	55,000	76,000

	Liabilities and Capital	
	Adjusted per books	Fair market value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of T's interest in the partnership and T's share of the adjusted basis to the partnership of the partnership's property. Under section 742, the basis of T's interest is $25,333 (the cash paid for A's interest, $22,000, plus $3,333, T's share of partnership liabilities). T's interest in the partnership's previously taxed capital is $15,000 ($22,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $7,000, the amount of tax gain allocated to T from the hypothetical transaction). T's share of the adjusted basis to the partnership of the partnership's property is $18,333 ($15,000 share of previously taxed capital, plus $3,333 share of the partnership's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is $7,000, the difference between $25,333 and $18,333.

Example 2. A, B, and C form partnership PRS, to which A contributes land (Asset 1) with a fair market value of $1,000 and an adjusted basis to A of $400, and B and C each contribute $1,000 cash. Each partner has $1,000 credited to it on the books of the partnership as its capital contribution. The partners share in profits equally. During the partnership's first taxable year, Asset 1 appreciates in value to $1,300. A sells its one-third interest in the partnership to T for $1,100, when an election under section 754 is in effect. The amount of tax gain that would be allocated to T from the hypothetical transaction is $700 ($600 section 704(c) built-in gain, plus one-third of the additional gain). Thus, T's interest in the partnership's previously taxed capital is $400 ($1,100, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $700, T's share of gain from the hypothetical transaction). The amount of T's basis adjustment under section 743(b) to partnership property is $700 (the excess of $1,100, T's cost basis for its interest, over $400, T's share of the adjusted basis to the partnership of partnership property).

(e) *Allocation of basis adjustment.* For the allocation of the basis adjustment under this section among the individual items of partnership property, see section 755 and the regulations thereunder.

(f) *Subsequent transfers.* Where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. In the case of a gift of an interest in a partnership, the donor is treated as transferring, and the donee as receiving, that portion of the basis adjustment attributable to the gifted partnership interest. The provisions of this paragraph (f) are illustrated by the following example:

Example. (i) A, B, and C form partnership PRS. A and B each contribute $1,000 cash, and C contributes land with a basis and fair market value of $1,000. When the land has appreciated in value to $1,300, A sells its interest to T1 for $1,100 (one-third of $3,300, the fair market value of the partnership property). An election under section 754 is in effect; therefore, T1 has a basis adjustment under section 743(b) of $100.

(ii) After the land has further appreciated in value to $1,600, T1 sells its interest to T2 for $1,200 (one-third of $3,600, the fair market value of the partnership property). T2 has a basis adjustment under section 743(b) of $200. This amount is determined without regard to any basis adjustment under section 743(b) that T1 may have had in the partnership assets.

(iii) During the following year, T2 makes a gift to T3 of fifty percent of T2's interest in PRS. At the time of the transfer, T2 has a $200 basis adjustment under section 743(b). T2 is treated as transferring $100 of the basis adjustment to T3 with the gift of the partnership interest.

(g) *Distributions*—(1) *Distribution of adjusted property to the transferee*—(i) *Coordination with section 732.* If a partnership distributes property to a transferee and the transferee has a basis adjustment for the property, the basis adjustment is taken into account under section 732. See § 1.732–2(b).

(ii) *Coordination with section 734.* For certain adjustments to the common basis of remaining partnership property after the distribution of adjusted property to a transferee, see § 1.734–2(b).

(2) *Distribution of adjusted property to another partner*—(i) *Coordination with section 732.* If a partner receives a distribution of property with respect to which another partner has a basis adjustment, the distributee does not take the basis adjustment into account under section 732.

(ii) *Reallocation of basis.* A transferee with a basis adjustment in property that is distributed to another partner reallocates the basis adjustment among the remaining items of partnership property under § 1.755–1(c).

(3) *Distributions in complete liquidation of a partner's interest.* If a transferee receives a distribution of property (whether or not the transferee has a basis adjustment in such property) in

liquidation of its interest in the partnership, the adjusted basis to the partnership of the distributed property immediately before the distribution includes the transferee's basis adjustment for the property in which the transferee relinquished an interest (either because it remained in the partnership or was distributed to another partner). Any basis adjustment for property in which the transferee is deemed to relinquish its interest is reallocated among the properties distributed to the transferee under § 1.755–1(c).

(4) *Coordination with other provisions.* The rules of sections 704(c)(1)(B), 731, 737, and 751 apply before the rules of this paragraph (g).

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

Example. (i) A, B, and C are equal partners in partnership PRS. Each partner originally contributed $10,000 in cash, and PRS used the contributions to purchase five nondepreciable capital assets. PRS has no liabilities. After five years, PRS's balance sheet appears as follows:

	Assets	
	Adjusted basis	Fair market value
Asset 1	$10,000	$10,000
Asset 2	4,000	6,000
Asset 3	6,000	6,000
Asset 4	7,000	4,000
Asset 5	3,000	13,000
Total	30,000	39,000

	Capital	
	Adjusted per books	Fair market value
Partner A	$10,000	$13,000
Partner B	10,000	13,000
Partner C	10,000	13,000
Total	30,000	39,000

(ii) A sells its interest to T for $13,000 when PRS has an election in effect under section 754. T receives a basis adjustment under section 743(b) in the partnership property that is equal to $3,000 (the excess of T's basis in the partnership interest, $13,000, over T's share of the adjusted basis to the partnership of partnership property, $10,000). The basis adjustment is allocated under section 755, and the partnership's balance sheet appears as follows:

	Assets		
	Adjusted basis	Fair market value	Basis adjustment
Asset 1	$10,000	$10,000	$0.00
Asset 2	4,000	6,000	666.67
Asset 3	6,000	6,000	0.00
Asset 4	7,000	4,000	(1,000.00)
Asset 5	3,000	13,000	3,333.33
Total	30,000	39,000	3,000.00

	Capital		
	Adjusted per books	Fair market value	Special basis
Partner T	$10,000	$13,000	$3,000
Partner B	10,000	13,000	0
Partner C	10,000	13,000	0
Total	30,000	39,000	3,000

(iii) Assume that PRS distributes Asset 2 to T in partial liquidation of T's interest in the partnership. T has a basis adjustment under section 743(b) of $666.67 in Asset 2. Under paragraph (g)(1)(i) of this section, T takes the basis adjustment into account under section 732. Therefore, T will have a basis in Asset 2 of $4,666.67 following the distribution.

(iv) Assume instead that PRS distributes Asset 5 to C in complete liquidation of C's interest in PRS. T has a basis adjustment under section 743(b) of $3,333.33 in Asset 5. Under paragraph (g)(2)(i) of this section, C does not take T's basis adjustment into account under section 732. Therefore, the partnership's basis for purposes of sections 732 and 734 is $3,000. Under paragraph (g)(2)(ii) of this section, T's $3,333.33 basis adjustment is reallocated among the remaining partnership assets under §1.755–1(c).

(v) Assume instead that PRS distributes Asset 5 to T in complete liquidation of its interest in PRS. Under paragraph (g)(3) of this section, immediately prior to the distribution of Asset 5 to T, PRS must adjust the basis of Asset 5. Therefore, immediately prior to the distribution, PRS's basis in Asset 5 is equal to $6,000, which is the sum of (A) $3,000, PRS's common basis in Asset 5, plus (B) $3,333.33, T's basis adjustment to Asset 5, plus (C) ($333.33), the sum of T's basis adjustments in Assets 2 and 4. For purposes of sections 732 and 734, therefore, PRS will be treated as having a basis in Asset 5 equal to $6,000.

(h) *Contributions of adjusted property*—(1) *Section 721(a) transactions.* If, in a transaction described in section 721(a), a partnership (the upper tier) contributes to another partnership (the lower tier) property with respect to which a basis adjustment has been made, the basis adjustment is treated as contributed to the lower-tier partnership, regardless of whether the lower-tier partnership makes a section 754 election. The lower tier's basis in the contributed assets and the upper tier's basis in the partnership interest received in the transaction are determined with reference to the basis adjustment. However, that portion of the basis of the upper tier's interest in the lower tier attributable to the basis adjustment must be segregated and allocated solely to the transferee partner for whom the basis adjustment was made. Similarly, that portion of the lower tier's basis in its assets attributable to the basis adjustment must be segregated and allocated solely to the upper tier and the transferee. A partner with a basis adjustment in property held by a partnership that terminates under section 708(b)(1)(B) will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under §1.708–1(b)(1)(iv), regardless of whether the new partnership makes a section 754 election.

(2) *Section 351 transactions*—(i) *Basis in transferred property*. A corporation's adjusted tax basis in property transferred to the corporation by a partnership in a transaction described in section 351 is determined with reference to any basis adjustments to the property under section 743(b) (other than any basis adjustment that reduces a partner's gain under paragraph (h)(2)(ii) of this section).

(ii) *Partnership gain*. The amount of gain, if any, recognized by the partnership on a transfer of property by the partnership to a corporation in a transfer described in section 351 is determined without reference to any basis adjustment to the transferred property under section 743(b). The amount of gain, if any, recognized by the partnership on the transfer that is allocated to a partner with a basis adjustment in the transferred property is adjusted to reflect the partner's basis adjustment in the transferred property.

(iii) *Basis in stock*. The partnership's adjusted tax basis in stock received from a corporation in a transfer described in section 351 is determined without reference to the basis adjustment in property transferred to the corporation in the section 351 exchange. A partner with a basis adjustment in property transferred to the corporation, however, has a basis adjustment in the stock received by the partnership in the section 351 exchange in an amount equal to the partner's basis adjustment in the transferred property, reduced by any basis adjustment that reduced the partner's gain under paragraph (h)(2)(ii) of this section.

(iv) *Example.* The following example illustrates the principles of this paragraph (h)(2):

Example. (i) A, B, and C are equal partners in partnership PRS. The partnership's only asset, Asset 1, has an adjusted tax basis of $60 and a fair market value of $120. Asset 1 is a nondepreciable capital asset and is not section 704(c) property. A has a basis in its partnership interest of $40, and a positive section 743(b) adjustment of $20 in Asset 1. In a transaction to which section 351 applies, PRS contributes Asset 1 to X, a corporation, in exchange for $15 in cash and X stock with a fair market value of $105.

(ii) Under paragraph (h)(2)(ii) of this section, PRS realizes $60 of gain on the transfer of Asset 1 to X ($120, its amount realized, minus $60, its adjusted basis), but recognizes only $15 of that gain under section 351(b)(1). Of this amount, $5 is allocated to each partner. A must use $5 of its basis adjustment in Asset 1 to offset A's share of PRS's gain. Under paragraph (h)(2)(iii) of this section, PRS's basis in the stock received from X is $60. However, A has a basis adjustment in the stock received by PRS equal to $15 (its basis adjustment in Asset 1, $20, reduced by the portion of the adjustment which reduced A's gain, $5). Under paragraph (h)(2)(i) of this section, X's basis in Asset 1 equals $90 (PRS's common basis in the asset, $60, plus the gain recognized by PRS under section 351(b)(1), $15, plus A's basis adjustment under section 743(b), $20, less the portion of the adjustment which reduced A's gain, $5).

(i) [Reserved]

(j) *Effect of basis adjustment*—(1) *In general.* The basis adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee only. No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under section 743(b) and this section. The adjustment to the basis of partnership property under section 743(b) has no effect on the partnership's computation of any item under section 703.

(2) *Computation of partner's distributive share of partnership items.* The partnership first computes its items of income, deduction, gain, or loss at the partnership level under section 703. The partnership then allocates the partnership items among the partners, including the transferee, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the transferee's distributive share of the items of partnership income, deduction, gain, or loss, in accordance with paragraphs (j)(3) and (4) of this section, to reflect the effects of the transferee's basis adjustment under section 743(b). These adjustments to the transferee's distributive shares must be reflected on Schedules K and K–1 of the partnership's return (Form 1065). These adjustments to the transferee's distributive shares do not affect the transferee's capital account.

(3) *Effect of basis adjustment in determining items of income, gain, or loss*—(i) *In general.* The amount of a transferee's income, gain, or loss from the sale or exchange of a partnership asset in which the transferee has a basis adjustment is equal to the transferee's share of the partnership's gain or loss from the sale of the asset (including any remedial allocations under §1.704–3(d)), minus the amount of the transferee's positive basis adjustment for the partnership asset (determined by taking into account the recovery of the basis adjustment under paragraph (j)(4)(i)(B) of this section) or plus the amount of the transferee's negative basis adjustment for the partnership asset (determined by taking into the account the recovery of the basis adjustment under paragraph (j)(4)(ii)(B) of this section).

(ii) *Examples.* The following examples illustrate the principles of this paragraph (j)(3):

Example 1. A and B form equal partnership PRS. A contributes nondepreciable property with a fair market value of $50 and an adjusted tax basis of $100. PRS will use the traditional allocation method under §1.704–3(b). B contributes $50 cash. A sells its interest to T for $50. PRS has an election in effect to adjust the basis of partnership property under section 754. T receives a negative $50 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS then sells the property for $60. PRS recognizes a book gain of $10 (allocated equally between T and B) and a tax loss of $40. T will receive an allocation of $40 of tax loss under the principles of section 704(c). However, because T has a negative $50 basis adjustment in the nondepreciable property, T recognizes a $10 gain from the partnership's sale of the property.

Example 2. A and B form equal partnership PRS. A contributes nondepreciable property with a fair market value of $100 and an adjusted tax basis of $50. B contributes $100 cash. PRS will use the traditional allocation method under §1.704–3(b). A sells its interest to T for $100. PRS has an election in effect to adjust the basis of partnership property under section 754. Therefore, T receives a $50 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS then sells the nondepreciable property for $90. PRS recognizes a book loss of $10 (allocated equally between T and B) and a tax gain of $40. T will receive an allocation of the entire $40 of tax gain under the principles of section 704(c). However, because T has a $50 basis adjustment in the property, T recognizes a $10 loss from the partnership's sale of the property.

Example 3. A and B form equal partnership PRS. PRS will make allocations under section 704(c) using the remedial allocation method described in §1.704–3(d). A contributes nondepreciable property with a fair market value of $100 and an adjusted tax basis of $150. B contributes $100 cash. A sells its partnership interest to T for $100. PRS has an election in effect to adjust the basis of partnership property under section 754. T receives a negative $50 basis adjustment under section 743(b) that, under section 755, is allocated to the property. The partnership then sells the property for $120. The partnership recognizes a $20 book gain and a $30 tax loss. The book gain will be allocated equally between the partners. The entire $30 tax loss will be allocated to T under the principles of section 704(c). To match its $10 share of book gain, B will be allocated $10 of remedial gain, and T will be allocated an offsetting $10 of remedial loss. T was allocated a total of $40 of tax loss with respect to the property. However, because T has a negative $50 basis adjustment to the property, T recognizes a $10 gain from the partnership's sale of the property.

(4) *Effect of basis adjustment in determining items of deduction*—(i) *Increases*—(A) *Additional deduction.* The amount of any positive basis adjustment that is recovered by the transferee in any year is added to the transferee's distributive share of the partnership's depreciation or amortization deductions for the year. The basis adjustment is adjusted under section 1016(a)(2) to reflect the recovery of the basis adjustment.

(B) *Recovery period*—(*1*) *In general.* Except as provided in paragraph (j)(4)(i)(B)(*2*) of this section, for purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the transfer of a partnership interest, then the increased portion of the basis is taken into account as if it were newly-purchased recovery property placed in service when the transfer occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

(*2*) *Remedial allocation method.* If a partnership elects to use the remedial allocation method described in §1.704–3(d) with respect to an item of the partnership's recovery property, then the portion of any increase in the basis of the item of the partnership's recovery property under section 743(b) that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final sentence of §1.704–3(d)(2). Any remaining portion of the basis increase is recovered under paragraph (j)(4)(i)(B)(*1*) of this section.

(C) *Examples.* The provisions of this paragraph (j)(4)(i) are illustrated by the following examples:

Example 1. (i) A, B, and C are equal partners in partnership PRS, which owns Asset 1, an item of depreciable property that has a fair market value in excess of its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, increases the basis of Asset 1 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 1 is $1,000. Also assume that, under paragraph (j)(4)(i)(B) of this section, the amount of the basis adjustment under section 743(b) that T recovers during the year is $500. The total amount of depreciation deductions from Asset 1 reported by T is equal to $1,500.

Example 2. (i) A and B form equal partnership PRS. A contributes property with an adjusted basis of $100,000 and a fair market value of $500,000. B contributes $500,000 cash. When PRS is formed, the property has five years remaining in its recovery period. The partnership's adjusted basis of $100,000 will, therefore, be recovered over the five years remaining in the property's recovery period. PRS elects to use the remedial allocation method under §1.704–3(d) with respect to the property. If PRS had purchased the property at the time of the partnership's formation, the basis of the property would have been recovered over a 10-year period. The $400,000 of section 704(c) built-in gain will, therefore, be amortized under §1.704-3(d) over a 10-year period beginning at the time of the partnership's formation.

(ii)(A) Except for the depreciation deductions, PRS's expenses equal its income in each year of the first two years commencing with the year the partnership is formed. After two years, A's share of the adjusted basis of partnership property is $120,000, while B's is $440,000:

	Capital accounts			
	A		B	
	Book	Tax	Book	Tax
Initial Contribution	$500,000	$100,000	$500,000	$500,000
Depreciation Year 1	(30,000)		(30,000)	(20,000)
Remedial		10,000		(10,000)
	470,000	110,000	470,000	470,000
Depreciation Year 2	(30,000)		(30,000)	(20,000)
Remedial		10,000		(10,000)
	440,000	120,000	440,000	440,000

(B) A sells its interest in PRS to T for its fair market value of $440,000. A valid election under section 754 is in effect with respect to the sale of the partnership interest. Accordingly, PRS makes an adjustment, pursuant to section 743(b), to increase the basis of partnership property. Under section 743(b), the amount of the basis adjustment is equal to $320,000. Under section 755, the entire basis adjustment is allocated to the property.

(iii) At the time of the transfer, $320,000 of section 704(c) built-in gain from the property was still reflected on the partnership's books, and all of the basis adjustment is attributable to section 704(c) built-in gain. Therefore, the basis adjustment will be recovered over the remaining recovery period for the section 704(c) built-in gain under § 1.704–3(d).

(ii) *Decreases*—(A) *Reduced deduction.* The amount of any negative basis adjustment allocated to an item of depreciable or amortizable property that is recovered in any year first decreases the transferee's distributive share of the partnership's depreciation or amortization deductions from that item of property for the year. If the amount of the basis adjustment recovered in any year exceeds the transferee's distributive share of the partnership's depreciation or amortization deductions from the item of property, then the transferee's distributive share of the partnership's depreciation or amortization deductions from other items of partnership property is decreased. The transferee then recognizes ordinary income to the extent of the excess, if any, of the amount of the basis adjustment recovered in any year over the transferee's distributive share of the partnership's depreciation or amortization deductions from all items of property.

(B) *Recovery period.* For purposes of section 168, if the basis of an item of a partnership's recovery property is decreased as the result of the transfer of an interest in the partnership, then the decrease is recovered over the remaining useful life of the item of the partnership's recovery property. The portion of the decrease that is recovered in any year during the recovery period is equal to the product of—

(*1*) The amount of the decrease to the item's adjusted basis (determined as of the date of the transfer); multiplied by

(*2*) A fraction, the numerator of which is the portion of the adjusted basis of the item recovered by the partnership in that year, and the denominator of which is the adjusted basis of the item on the date of the transfer (determined prior to any basis adjustments).

(C) *Examples.* The provisions of this paragraph (j)(4)(ii) are illustrated by the following examples:

Example 1. (i) A, B, and C are equal partners in partnership PRS, which owns Asset 2, an item of depreciable property that has a fair market value that is less than its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, decreases the basis of Asset 2 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 2 is $1,000. Also assume that, under paragraph (j)(4)(ii)(B) of this section, the amount of the basis adjustment under section 743(b) that T recovers during the year is $500. The total amount of depreciation deductions from Asset 2 reported by T is equal to $500.

Example 2. (i) A and B form equal partnership PRS. A contributes property with an adjusted basis of $100,000 and a fair market value of $50,000. B contributes $50,000 cash. When PRS is formed, the property has five years remaining in its recovery period. The partnership's adjusted basis of $100,000 will, therefore, be recovered over the five years remaining in the property's recovery period. PRS uses the traditional allocation method under § 1.704–3(b) with respect to the property. As a result, B will receive $5,000 of depreciation deductions from the property in each of years 1–5, and A, as the contributing partner, will receive $15,000 of depreciation deductions in each of these years.

(ii) Except for the depreciation deductions, PRS's expenses equal its income in each of the first two years commencing with the year the partnership is formed. After two years, A's share of the adjusted basis of partnership property is $70,000, while B's is $40,000. A sells its interest in PRS to T for its fair market value of $40,000. A valid election under section 754 is in effect with respect to the sale of the partnership interest. Accordingly, PRS makes an adjustment, pursuant to section 743(b), to decrease the basis of partnership property. Under section 743(b), the amount of the adjustment is equal to ($30,000). Under section 755, the entire adjustment is allocated to the property.

(iii) The basis of the property at the time of the transfer of the partnership interest was $60,000. In each of years 3 through 5, the partnership will realize depreciation deductions of $20,000 from the property. Thus, one third of the negative basis adjustment ($10,000) will be recovered in each of years 3 through 5. Consequently, T will be allocated, for tax purposes, depreciation of $15,000 each year from the partnership and will recover $10,000 of its negative basis adjustment. Thus, T's net depreciation deduction from the partnership in each year is $5,000.

Example 3. (i) A, B, and C are equal partners in partnership PRS, which owns Asset 2, an item of depreciable property that has a fair market value that is less than its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, decreases the basis of Asset 2 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 2 is $500. PRS allocates no other depreciation to T. Also assume that, under paragraph (j)(4)(ii)(B) of this section, the amount of the negative basis adjustment that T recovers during the year is $1,000. T will report $500 of ordinary income because the amount of the negative basis adjustment recovered during the year exceeds T's distributive share of the partnership's common basis depreciation deductions from Asset 2.

(5) *Depletion.* Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowance is determined separately for each partner, including the transferee partner, based on the partner's interest in such property. See § 1.702–1(a)(8). For partnerships that hold oil and gas properties that are depleted at the partner level under section 613A(c)(7)(D), the transferee partner (and not the partnership) must make the basis adjustments, if any, required under section 743(b) with respect to such properties. See § 1.613A–3(e)(6)(iv).

(6) *Example.* The provisions of paragraph (j)(5) of this section are illustrated by the following example:

Example. A, B, and C each contributes $5,000 cash to form partnership PRS, which purchases a coal property for $15,000. A, B, and C have equal interests in capital and profits. C subsequently sells its partnership interest to T for $100,000 when the election under section 754 is in effect. T has a basis adjustment under section 743(b) for the coal property of $95,000 (the difference between T's basis, $100,000, and its share of the basis of partnership property, $5,000). Assume that the depletion allowance computed under the percentage method would be $21,000 for the taxable year so that each partner would be entitled to $7,000 as its share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to T's one-third interest which has a basis to him of $100,000 ($5,000, plus its basis adjustment of $95,000) is $10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the coal property, each of which has a basis of $5,000, is only $500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct $7,000 based on the percentage depletion method. However, as to T, the transferee partner, the cost depletion method results in a greater allowance and T will, therefore, deduct $10,000 based on cost depletion. See section 613(a).

(k) *Returns*—(1) *Statement of adjustments*—(i) *In general.* A partnership that must adjust the bases of partnership properties under section 743(b) must attach a statement to the partnership return for the year of the transfer setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(ii) *Special rule.* Where an interest is transferred in a partnership which holds oil and gas properties that are depleted at the partner level under section 613A(c)(7)(D), the transferee must attach a statement to the transferee's return for the year of the transfer, setting forth the computation of the basis adjustment under section 743(b) which is allocable to such properties and the specific properties to which the adjustment has been allocated.

(iii) *Example.* The provisions of paragraph (k)(1)(ii) of this section are illustrated by the following example:

Example. (i) Partnership XYZ owns a single section 613A(c)(7)(D) domestic oil and gas property (Property) and other non-depletable assets. A, a partner in XYZ with an adjusted tax basis in Property of $100 (excluding any prior adjustments under section 743(b)), sells its partnership interest to B for $800 cash. Under §1.613A–3(e)(6)(iv), A's adjusted basis of $100 in Property carries over to B.

(ii) Under section 755, XYZ determines that Property accounts for 50% of the fair market value of all partnership assets. The remaining 50% of B's purchase price ($400) is attributable to non-depletable property. XYZ must provide a statement to B containing the portion of B's adjusted basis attributable to non-depletable property ($400). Under this paragraph (k)(1), XYZ must report basis adjustments under section 743(b) to non-depletable property. B must report basis adjustments under section 743(b) to Property.

(2) *Requirement that transferee notify partnership*—(i) *Sale or exchange.* A transferee that acquires, by sale or exchange, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange. The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the transferee and (if ascertainable) of the transferor, the taxpayer identification numbers of the transferee and (if ascertainable) of the transferor, the relationship (if any) between the transferee and the transferor, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of any money, the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership, and any other information necessary for the partnership to compute the transferee's basis.

(ii) *Transfer on death.* A transferee that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner. The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the relationship (if any) between the transferee and the transferor, the deceased partner's date of death, the date on which the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in section 1014, and the manner in which the fair market value of the partnership interest was determined.

(iii) *Nominee reporting.* If a partnership interest is transferred to a nominee which is required to furnish the statement under section 6031(c)(1) to the partnership, the nominee may satisfy the notice requirement contained in this paragraph (k)(2) by providing the statement required under §1.6031(c)–1T, provided that the statement satisfies all requirements of §1.6031(c)–1T and this paragraph (k)(2).

(3) *Reliance.* In making the adjustments under section 743(b) and any statement or return relating to such adjustments under this section, a partnership may rely on the written notice provided by a transferee pursuant to paragraph (k)(2) of this section to determine the transferee's basis in a partnership interest. The previous sentence shall not apply if any partner who has responsibility for federal income tax reporting by the partnership has knowledge of facts indicating that the statement is clearly erroneous.

(4) *Partnership not required to make or report adjustments under section 743(b) until it has notice of the transfer.* A partnership is not required to make the adjustments under section 743(b) (or any statement or return relating to those adjustments) with respect to any transfer until it has been notified of the transfer. For purposes of this section, a partnership is notified of a transfer when either—

(i) The partnership receives the written notice from the transferee required under paragraph (k)(2) of this section; or

(ii) Any partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest.

(5) *Effect on partnership of the failure of the transferee to comply.* If the transferee fails to provide the partnership with the written notice required by paragraph (k)(2) of this section, the partnership must attach a statement to its return in the year that the partnership is otherwise notified of the transfer. This statement must set forth the name and taxpayer identification number (if ascertainable) of the transferee. In addition, the following statement must be prominently displayed in capital letters on the first page of the partnership's return for such year, and on the first page of any schedule or information statement relating to such transferee's share of income, credits, deductions, etc.: ''RETURN FILED PURSUANT TO §1.743–1(k)(5).'' The partnership will then be entitled to report the transferee's share of partnership items without adjustment to reflect the transferee's basis adjustment in partnership property. If, following the filing of a return pursuant to this paragraph (k)(5), the transferee provides the applicable written notice to the partnership, the partnership must make such adjustments as are necessary to adjust the basis of partnership property (as of the date of the transfer) in any amended return otherwise to be filed by the partnership or in the next annual partnership return of income to be regularly filed by the partnership. At such time, the partnership must also provide the transferee with such information as is necessary for the transferee to amend its prior returns to properly reflect the adjustment under section 743(b).

(l) *Effective date.* This section applies to transfers of partnership interests that occur on or after December 15, 1999.

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PROVISIONS COMMON TO PART II, SUBCHAPTER K, CHAPTER 1 OF THE CODE

§ 1.751–1 Unrealized receivables and inventory items.

(a) *Sale or exchange of interest in a partnership*—(1) *Character of amount realized.* To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of ''unrealized receivables'' and ''inventory items which have appreciated substantially in value'', see section 751 (c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as ''section 751 property''. See paragraph (e) of this section.

(2) *Determination of gain or loss.* The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under §1.704–3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any

gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest.

(3) *Statement required.* A partner selling or exchanging any part of an interest in a partnership that has any section 751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information—

(i) The date of the sale or exchange;

(ii) The amount of any gain or loss attributable to the section 751 property; and

(iii) The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

(b) *Certain distributions treated as sales or exchanges*—(1) *In general.* (i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of $100,000 in which partner A has an interest of 30 percent, or $30,000. If A receives $20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the $80,000 of section 751 property remaining in the partnership after the distribution, only $6,000 ($30,000 minus $24,000 (30 percent of $80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining $14,000 ($20,000 minus $6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) *Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).* (i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) *Distribution of partnership property other than section 751 property*. (i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).

(4) *Exceptions*. (i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736–1.

(5) *Statement required.* A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) *Unrealized receivables.* (1) The term *unrealized receivables,* as used in subchapter K, chapter 1 of the Code, means any rights (contractual or otherwise) to payment for:

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(4)(i) With respect to any taxable year of a partnership ending after September 12, 1966 (but only in respect of expenditures paid or incurred after that date), the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from mining property defined in section 617(f)(2). With respect to each item of partnership mining property so defined, the potential gain is the amount that would be treated as gain to which section 617(d)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(ii) With respect to sales, exchanges, or other dispositions after December 31, 1975, in any taxable year of a partnership ending after that date, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in a DISC as described in section 992(a). With respect to stock in such a DISC, the potential gain is the amount that would be treated as gain to which section 995(c) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(iii) With respect to any taxable year of a partnership beginning after December 31, 1962, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1245 property. With respect to each item of partnership section 1245 property (as defined in section 1245(a)(3)), potential gain from section 1245 property is the amount that would be treated as gain to which section 1245(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1245 property were sold by the partnership at its fair market value. See § 1.1245–1(e)(1). For example, if a partnership would recognize under section 1245(a)(1) gain of $600 upon a sale of one item of section 1245 property and gain of $300 upon a sale of its only other item of such property, the potential section 1245 income of the partnership would be $900.

(iv) With respect to transfers after October 9, 1975, and to sales, exchanges, and distributions taking place after that date, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in certain foreign corporations as described in section 1248. With respect to stock in such a foreign corporation, the potential gain is the amount that would be treated as gain to which section 1248(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(v) With respect to any taxable year of a partnership ending after December 31, 1963, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1250 property. With respect to each item of partnership section 1250 property (as defined in section 1250(c)), potential gain from section 1250 property is the amount that would be treated as gain to which section 1250(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1250 property were sold by the partnership at its fair market value. See § 1.1250–1(f)(1).

(vi) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm recapture property as defined in section 1251(e)(1) (as in effect before enactment of the Tax Reform Act of 1984). With respect to each item of partnership farm recapture property so defined, the potential gain is the amount which would be treated as gain to which section 1251(c) (as in effect before enactment of the Tax Reform Act of 1984) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(vii) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm land as defined in section 1252(a)(2). With respect to each item of partnership farm land so defined, the potential gain is the amount that would be treated as gain to which section 1252(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(viii) With respect to transactions which occur after December 31, 1976, in any taxable year of a partnership ending after that date, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from franchises, trademarks, or trade names referred to in section 1253(a). With respect to each such item so referred to in section 1253(a), the potential gain is the amount that would be treated as gain to which section 1253(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the items were sold by the partnership at its fair market value.

(ix) With respect to any taxable year of a partnership ending after December 31, 1975, the term *unrealized receivables,* for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain under section 1254(a) from natural resource recapture property as defined in § 1.1254–1(b)(2). With respect to each separate partnership natural resource recapture property so described, the potential gain is the amount that would be treated as gain to which section 1254(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the property were sold by the partnership at its fair market value.

(5) For purposes of subtitle A of the Internal Revenue Code, the basis of any potential gain described in paragraph (c)(4) of this section is zero.

(6)(i) If (at the time of any transaction referred to in paragraph (c)(4) of this section) a partnership holds property described in paragraph (c)(4) of this section and if—

(A) A partner had a special basis adjustment under section 743(b) in respect of the property;

(B) The basis under section 732 of the property if distributed to the partner would reflect a special basis adjustment under section 732(d); or

(C) On the date a partner acquired a partnership interest by way of a sale or exchange (or upon the death of another partner) the partnership owned the property and an election under section 754 was in effect with respect to the partnership, the partner's share of any potential gain described in paragraph (c)(4) of this section is determined under paragraph (c)(6)(ii) of this section.

(ii) The partner's share of the potential gain described in paragraph (c)(4) of this section in respect of the property to which this paragraph (c)(6)(ii) applies is that amount of gain that the partner would recognize under section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1251(c) (as in effect before the Tax Reform Act of 1984), 1252(a), 1253(a), or 1254(a) (as the case may be) upon a sale of the property by the partnership, except that, for purposes of this paragraph (c)(6) the partner's share of such gain is determined in a manner that is consistent with the manner in which the partner's share of partnership property is determined; and the amount of a potential special basis adjustment under section 732(d) is treated as if it were the amount of a special basis adjustment under section 743(b). For example, in determining, for purposes of this paragraph (c)(6), the amount of gain that a partner would recognize under section 1245 upon a sale of partnership property, the items allocated under § 1.1245–1(e)(3)(ii) are allocated to the partner in the same manner as the partner's share of partnership property is determined. See § 1.1250–1(f) for rules similar to those contained in § 1.1245–1(e)(3)(ii).

(d) *Inventory items which have substantially appreciated in value*—(1) *Substantial appreciation.* Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms ''inventory items which have appreciated substantially in value'' or ''substantially appreciated inventory items'' refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the ''fair market value'' of inventory items has the same meaning as ''market'' value in the regulations under section 471, relating to general rule for inventories.

(2) *Inventory items.* The term *inventory items* as used in subchapter K, chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(1).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivision (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) *Section 751 property and other property.* For the purposes of this section, *section 751 property* means unrealized receivables or substantially appreciated inventory items, and *other property* means all property (including money) except section 751 property.

(f) *Effective date.* Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of subchapter K, chapter 1 of the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of § 1.771–1. See also section 771(c) and paragraph (c) of § 1.771–1. The rules contained in paragraphs (a)(2) and (a)(3) of this section apply to transfers of partnership interests that occur on or after December 15, 1999.

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples:

Example 1. (i)(A) A and B are equal partners in personal service partnership PRS. B transfers its interest in PRS to T for $15,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	Assets	
	Adjusted basis	Fair market value
Cash	$3,000	$3,000
Loans Receivable	10,000	10,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	20,000	32,000

	Liabilities and Capital	
	Adjusted per books	Fair market value
Liabilities	$2,000	$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000

	Liabilities and Capital	
	Adjusted per books	Fair market value
Total	20,000	32,000

(B) None of the assets owned by PRS is section 704(c) property, and the capital assets are nondepreciable. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by T. See section 752. B's undivided half-interest in the partnership property includes a half-interest in the partnership's unrealized receivables items. B's basis for its partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). If section 751(a) did not apply to the sale, B would recognize $6,000 of capital gain from the sale of the interest in PRS. However, section 751(a) does apply to the sale.

(ii) If PRS sold all of its section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($6,000) and the amount of ordinary income or loss determined under paragraph (a)(2) of this section ($7,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $1,000 capital loss.

Example 2. (a) *Facts.* Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$15,000	$15,000
Accounts receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable property	42,000	48,000
Land	9,000	9,000
Total	96,000	11,000

LIABILITIES AND CAPITAL

	Per books	Value
Current liabilities	$15,000	$15,000
Mortgage payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	20,000	25,000
Total	96,000	111,000

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

(b) *Presence of section 751 property.* The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, $39,000 (inventory $30,000, and accounts receivable $9,000), exceeds 120 percent of the $30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, $39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of $96,000 or $9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash ($5,000) and $15,000 in depreciable property ($1,000 less than his $16,000 share). In addition, he received other partnership property ($5,000 cash and $12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable ($3,000), inventory ($10,000), land ($3,000), and the balance of his interest in depreciable property ($1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of $13,000 ($3,000 in accounts receivable and $10,000 in inventory). Thus,

$13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of $22,000 for the remainder of his partnership interest. The total distribution to C was $37,000 ($22,000 in cash and liabilities assumed, and $15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732(b), C's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the $22,000 money distributed (in cash and the assumption of C's share of liabilities), $13,000 was paid to acquire C's interest in inventory ($10,000 fair market value) and in accounts receivable ($3,000). Since under section 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is $13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable ($30,000) by $10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by $13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from $21,000 to $24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See paragraph (e) of §1.732–1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: $15,000 in depreciable property (with a basis to the partnership of $15,000) and $9,000 in money ($22,000 less $13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property before the distribution, $42,000, is reduced by the basis of the depreciable property distributed, $15,000, leaving a basis for the depreciable property in the partnership of $27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been $15,000, and is only $13,000 in C's hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by $2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be $38,000 ($20,000 original contribution, plus $12,000, each partner's original share of the

liabilities, plus $6,000, the share of C's liabilities each assumed).

(f) *Partnership trial balance.* A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

Example 3. (a) *Facts.* Assume that the distribution to partner C in example 2 of this paragraph in liquidation of his entire interest in partnership ABC consists of $5,000 in cash and $20,000 worth of partnership inventory with a basis of $14,000.

	I		II	
	Sec.754, Election in effect		Sec.754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	$5,000	$5,000	$5,000	$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
	76,000	86,000	74,000	86,000
Current liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
	20,000	25,000	20,000	25,000
	20,000	25,000	20,000	25,000
	76,000	86,000	76,000	86,000

(b) *Presence of section 751 property.* For the same reason as stated in paragraph (b) of example 2, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* In the distribution, C received his share of cash ($5,000) and his share of appreciated inventory items ($13,000). In addition, he received appreciated inventory with a fair market value of $7,000 (and with an adjusted basis to the partnership of $4,900) and $12,000 in money (liabilities assumed). C has relinquished his interest in $16,000 of depreciable property and $3,000 of land. Although C relinquished his interest in $3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., depreciable property or land for inventory items). Assume that the partners agree that the $7,000 of inventory in excess of C's share was received by him in exchange for $7,000 of depreciable property.

(d) *Distributee partner's tax consequences.* C's tax consequence on the distributions are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/16ths share of the depreciable property in a current distribution. His basis for that share is $6,125 (42,000/48,000 of $7,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for $7,000, realizing a gain of $875.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000, plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of $25,875 for the remainder of his partnership interest. Of the $37,000 total distribution to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of $13,000 (which had an adjusted basis to the partnership of $9,100) is limited to $8,875, the amount of the remaining basis for his partnership interest, $25,875, reduced by $17,000, the money received. Thus, C's total aggregate basis for the inventory received is $15,875 ($7,000 plus $8,875), and not its $14,000 basis in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of the $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is $42,875 ($42,000 less $6,125, the basis of the 7/16ths share considered as distributed to C, plus $7,000, the partnership purchase price for this share).

(2) *The part of the distribution not under section 751 (b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the

basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100, and C's basis for such inventory after distribution is only $8,875. The basis of the inventory remaining in the partnership must be increased by $225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities now assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example 4. (a) *Facts.* Assume the same facts as in example 3 of this paragraph, except that the partners did not identify the property which C relinquished in exchange for the $7,000 of inventory which he received in excess of his share.

(b) *Presence of section 751 property.* For the same reasons stated in paragraph (b) of example 2 of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* The analysis stated in paragraph (c) of example 3 of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received $7,000 of inventory in exchange for his release of 7/19ths of the depreciable property and 7/19ths of the land. ($7,000, fair market value of property released, over $19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.)

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is $6,263 (51,000/57,000 of $7,000, their fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership for $7,000, realizing a gain of $737.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of $25,737 for the remainder of his partnership interest. Of the total $37,000 distributed to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory (with a fair market value of $13,000 and an adjusted basis to the partnership of $9,100) is limited to $8,737, the amount of the remaining basis for his partnership interest ($25,737 less $17,000, money received. Thus, C's total aggregate basis for the inventory he received is $15,737 ($7,000 plus $8,737), and not the $14,000 basis it had in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/19ths of C's interest in the depreciable property and land. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be $42,737 and $9,000, respectively. The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $5,158 basis (42,000/48,000 of $5,895) for C's 7/19ths interest constructively distributed and increased by $5,895 (16,000/19,000 of $7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $1,105 basis ($9,000/9,000 of $1,105) of land constructively distributed to C, and increased by $1,105 (3,000/19,000 of $7,000), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100 and C's basis for such inventory after the distribution is only $8,737. The basis of the inventory remaining in the partnership must be increased by the difference of $363. Whether or not an election

under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example 5. (a) *Facts.* Assume that partner C in example 2 of this paragraph agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by $4,800 from $12,000 (1/3 of $36,000) to $7,200 (1/5 of $36,000).

(b) *Presence of section 751 property.* For the same reasons as stated in paragraph (b) of example 2 of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

Item	C's interest Fair Market Value		C received		C relinquished
	One-third before	One-fifth after	Distribution of share	In excess of share	
Cash	$5,000	$2,000	$3,000	$2,000	
Liabilities assumed	(12,000)	(7,200)		4,800	
Inventory items:					
Accounts receivable	3,000	300	2,700	4,800	
Inventory	10,000	6,000			$4,000
Depreciable property	16,000	9,600			6,400
Land	3,000	1,800			1,200
Total	25,000	12,500	5,700	11,600	11,600

Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute section 751 property and C has received only $800 of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within section 751(b) and is a current distribution under section 732(a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* Assuming that the partners paid $800 worth of accounts receivable for $800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C's interest are illustrated in the following table:

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Original basis for C's interest	$32,000	$32,000	$32,000

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Less basis of property distributed prior to sec. 751 (b) sale or exchange	−700	−800	−716
	31,300	31,200	31,284
Less money received in distribution	−9,800	−9,800	−9,800
	21,500	21,400	21,484
Less basis of property received in a current distribution under sec. 732	−6,700	−6,700	−6,700
Resulting basis for C's interest	14,800	14,700	14,784

C's basis for the $1,500 worth of accounts receivable which he received in the distribution will be $7,500, composed of $800 for the portion purchased in the section 751(b) exchange, plus $6,700, the basis carried over under section 732(a) for the portion received in the current distribution.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership realizes no gain or loss in the section 751 sale or exchange because it had a basis of $800 for the accounts receivable for which it received $800 worth of other property. If the partnership agreed to purchase $800 worth of depreciable property, the partnership basis of depreciable property becomes $42,100 ($42,000 less $700 basis of property constructively distributed to C, plus $800, price of property purchased). If the partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be $51,084 (depreciable property, $42,084 and land $9,000). The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000 of $674) for C's $674 interest constructively distributed, and increased by $674 (6,400/7,600 of $800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land constructively distributed to C, and increased by $126 (1,200/7,600 of $800), the portion of the purchase price allocated to the land.

(2) *The part of the distribution not under section 751(b).* The partnership will realize no gain or loss in the balance of the distribution under section 731. Since the property in C's hands after the distribution will have the same basis it had in the partnership, the basis of partnership property remaining in the partnership after the distribution will not be adjusted (whether or not an election under 754 is in effect).

Example 6. (a) *Facts.* Partnership ABC distributes to partner C, in liquidation of his entire one-third interest in the partnership, a machine which is section 1245 property with a recomputed basis (as defined in section 1245(a)(2)) of $18,000. At the time of the distribution, the balance sheet of the partnership is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Machine (section 1245 property)	9,000	15,000
Land	18,000	27,000
Total	30,000	45,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$0	$0
Capital:		
A	10,000	15,000
B	10,000	15,000
C	10,000	15,000
Total	30,000	45,000

(b) *Presence of section 751 property.* The section 1245 property is an unrealized receivable of the partnership to the extent of the potential section 1245 income in respect of the property. Since the fair market value of the property ($15,000) is lower than its recomputed basis ($18,000), the excess of the fair market value over its adjusted basis ($9,000), or $6,000, is the potential section 1245 income of the partnership in respect of the property. The partnership has no other section 751 property.

(c) *The properties exchanged.* In the distribution C received his share of section 751 property (potential section 1245 income of $2,000, i.e., 1/3 of $6,000) and his share of section 1245 property (other than potential section 1245 income) with a fair market value of $3,000, i.e., 1/3 of ($15,000 minus $6,000), and an adjusted basis of $3,000, i.e., 1/3 of $9,000. In addition he received $4,000 of section 751 property (consisting of $4,000 ($6,000 minus $2,000) of potential section 1245 income) and section 1245 property (other than potential section 1245 income) with a fair market value of $6,000 ($9,000 minus $3,000) and an adjusted basis of $6,000 ($9,000 minus $3,000). C relinquished his interest in $1,000 of cash and $9,000 of land. Assume that the partners agree that the $4,000 of section 751 property in excess of C's share was received by him in exchange for $4,000 of land.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distributions are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he received in a current distribution 4/9ths of his share of the land with a basis of $2,667 (18,000/27,000×$4,000). Then C is considered as having sold his 4/9ths share of the land to the partnership for $4,000, realizing a gain of $1,333. C's basis for the remainder of his partnership interest after the current distribution is $7,333, i.e., the basis of his partnership interest before the current distribution ($10,000) minus the basis of the land treated as distributed to him ($2,667).

(2) *The part of the distribution not under section 751(b).* Of the $15,000 total distribution to C, $11,000 ($2,000 of potential section 1245 income and $9,000 section 1245 property other than potential section 1245 income) is not within section 751(b). Under section 732(b) and (c), C's basis for his share of potential section 1245 income is zero (see paragraph (c)(5) of this section) and his basis for $9,000 of section 1245 property (other than potential section 1245 income) is $7,333, i.e., the amount of the remaining basis for his partnership interest ($7,333) reduced by the basis for his share of potential section 1245 income (zero). Thus C's total aggregate basis for the section 1245 property (fair market value of $15,000) distributed to him is $11,333 ($4,000 plus $7,333). For an illustration of the computation of his recomputed basis for the section 1245 property immediately after the distribution, see example 2 of paragraph (f)(3) of §1.1245–4.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* Upon the sale of $4,000 potential section 1245 income, with a basis of zero, for 4/9ths of C's interest in the land, the partnership consisting of the remaining members has $4,000 ordinary income under sections 751(b) and 1245(a)(1). See section 1245(b)(3) and (6)(A). The partnership's new basis for the land is $19,333, i.e., $18,000, less the basis of the 4/9ths share considered as distributed to C ($2,667), plus the partnership purchase price for this share ($4,000).

(2) *The part of the distribution not under section 751(b).* The analysis under this subparagraph should be made in accordance with the principles illustrated in paragraph (e)(2) of examples 3, 4, and 5 of this paragraph.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8575, July 7, 1965; T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 8586, 60 FR 2500, Jan. 10, 1995; T.D. 8847, 64 FR 69915, Dec. 15, 1999]

§ 1.752–0 Table of Contents.

This section lists the captions that appear in §§1.752–1 through 1.752–5.

[T.D. 8380, 56 FR 66350, Dec. 23, 1991]

§ 1.752–1 Treatment of partnership liabilities.

(a) *Definitions.* For purposes of section 752, the following definitions apply:

(1) *Recourse liability defined.* A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752–2.

(2) *Nonrecourse liability defined.* A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under § 1.752–2.

(3) *Related person.* Related person means a person having a relationship to a partner that is described in § 1.752–4(b).

(b) *Increase in partner's share of liabilities.* Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership.

(c) *Decrease in partner's share of liabilities.* Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner.

(d) *Assumption of liability.* Except as otherwise provided in paragraph (e) of this section, a person is considered to assume a liability only to the extent that:

(1) The assuming person is personally obligated to pay the liability; and

(2) If a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability immediately after the assumption.

(e) *Property subject to a liability.* If property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution or distribution.

(f) *Netting of increases and decreases in liabilities resulting from same transaction.* If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to or distribution from a partnership of property subject to a liability or the termination of the partnership under section 708(b) will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction. When two or more partnerships merge or consolidate under section 708(b)(2)(A), as described in § 1.708–1(c)(3)(i), increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under section 752.

(g) *Example.* The following example illustrates the principles of paragraphs (b), (c), (e), and (f) of this section.

Example 1. Property contributed subject to a liability; netting of increase and decrease in partner's share of liability. B contributes property with an adjusted basis of $1,000 to a general partnership in exchange for a one-third interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of $150 and has a fair market value in excess of $150. After the contribution, B remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under paragraph (e) of this section, the partnership is treated as having assumed the $150 liability. As a result, B's individual liabilities decrease by $150. At the same time, however, B's share of liabilities of the partnership increases by $150. Only the net increase or decrease in B's share of the liabilities of the partnership and B's individual liabilities is taken into account in applying section 752. Because there is no net change, B is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership under paragraph (b) or (c) of this section. Therefore B's basis for B's partnership interest is $1,000 (B's basis for the contributed property).

Example 2. Merger or consolidation of partnerships holding property encumbered by liabilities. (i) B owns a 70 percent interest in partnership T. Partnership T's sole asset is property X, which is encumbered by a $900 liability. Partnership T's adjusted basis in property X is $600, and the value of property X is $1,000. B's adjusted basis in its partnership T interest is $420. B also owns a 20 percent interest in partnership S. Partnership S's sole asset is property Y, which is encumbered by a $100 liability. Partnership S's adjusted basis in property Y is $200, the value of property Y is $1,000, and B's adjusted basis in its partnership S interest is $40.

(ii) Partnership T and partnership S merge under section 708(b)(2)(A). Under section 708(b)(2)(A) and § 1.708–1(c)(1), partnership T is considered terminated and the resulting partnership is considered a continuation of partnership S. Partnerships T and S undertake the form described in § 1.708–1(c)(3)(i) for the partnership merger. Under § 1.708–1(c)(3)(i), partnership T contributes property X and its $900 liability to partnership S in exchange for an interest in partnership S. Immediately thereafter, partnership T distributes the interests in partnership S to its partners in liquidation of their interests in partnership T. B owns a 25 percent interest in partnership S after partnership T distributes the interests in partnership S to B.

(iii) Under paragraph (f) of this section, B nets the increases and decreases in its share of partnership liabilities associated with the merger of partnership T and partnership S. Before the merger, B's share of partnership liabilities was $650 (B had a $630 share of partnership liabilities in partnership T and a $20 share of partnership liabilities in partnership S immediately before the merger). B's share of S's partnership liabilities after the merger is $250 (25 percent of S's total partnership liabilities of $1,000). Accordingly, B has a $400 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a $400 distribution from partnership S under section 752(b). Because B's adjusted basis in its partnership S interest before the deemed distribution under section 752(b) is $460 ($420 + $40), B will not recognize gain under section 731. After the merger, B's adjusted basis in its partnership S interest is $60.

(h) *Sale or exchange of a partnership interest.* If a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder. For example, if a partner sells an interest in a partnership for $750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of $250, the seller realizes $1,000 on the transaction.

(i) *Bifurcation of partnership liabilities.* If one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability.

[T.D. 8380, 56 FR 66351, Dec. 23, 1991, as amended by T.D. 8925, 66 FR 723, Jan. 4, 2001]

§ 1.752–2 Partner's share of resource liabilities.

(a) *In general.* A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (j) of this section.

(b) *Obligation to make a payment.* (1) *In general.* Except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

(i) All of the partnership's liabilities become payable in full;

(ii) With the exception of property contributed to secure a partnership liability (see § 1.752–2(h)(2)), all of the partnership's assets, including cash, have a value of zero;

(iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors's right to repayment is limited solely to one or more assets of the partnership);

(iv) All items of income, gain, loss, or deduction are allocated among the partners; and

(v) The partnership liquidates.

(2) *Treatment upon deemed disposition.* For purposes of paragraph (b)(1) of this section, gain or loss on the deemed disposition of the partnership's assets is computed in accordance with the following:

(i) If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent section 704(c) or § 1.704–1(b)(4)(i) applies) in those assets.

(ii) A loss is recognized equal to the remaining tax basis (or book value to the extent section 704(c) or § 1.704–1(b)(4)(i) applies) of all the partnership's assets not taken into account in paragraph (b)(2)(i) of this section.

(3) *Obligations recognized.* The determination of the extent to which a partner or related person has an obligation to make a payment under paragraph (b)(1) of this section is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including:

(i) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;

(ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and

(iii) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.

To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), paragraph (b) of this section is applied as if the obligation did not exist.

(4) *Contingent obligations.* A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

(5) *Reimbursement rights.* A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner.

(6) *Deemed satisfaction of obligation.* For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. See §1.752–2(j).

(c) *Partner or related person as lender*—(1) *In general.* A partner bears the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner.

(2) *Wrapped debt.* If a partnership liability is owed to a partner or related person and that liability includes (*i.e.,* is "wrapped" around) a nonrecourse obligation encumbering partnership property that is owed to another person, the partnership liability will be treated as two separate liabilities. The portion of the partnership liability corresponding to the wrapped debt is treated as a liability owed to another person.

(d) *De minimis exceptions*—(1) *Partner as lender.* The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed).

(2) *Partner as guarantor.* The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.

(e) *Special rule for nonrecourse liability with interest guaranteed by a partner*—(1) *In general.* For purposes of this section, if one or more partners or related persons have guaranteed the payment of more than 25 percent of the total interest that will accrue on a partnership nonrecourse liability over its remaining term, and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities. If this rule applies, the partner or related person that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments. The remainder of the stated principal amount of the partnership liability constitutes a nonrecourse liability. Generally, in applying this rule, it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if, upon a default in payment by the partnership, the lender can enforce the interest guaranty without foreclosing on the property and thereby extinguishing the underlying debt. The guarantee of interest rule continues to apply even after the point at which the amount of guaranteed interest that will accrue is less than 25 percent of the total interest that will accrue on the liability.

(2) *Computation of present value.* The present value of the guaranteed future interest payments is computed using a discount rate equal to either the interest rate stated in the loan documents, or if interest is imputed under either section 483 or section 1274, the applicable federal rate, compounded semi-annually. The computation takes into account any payment of interest that the partner or related person may be required to make only to the extent that the interest will accrue economically (determined in accordance with section 446 and the regulations thereunder) after the date of the interest guarantee. If the loan document contains a variable rate of interest that is an interest rate based on current values of an objective interest index, the present value is computed on the assumption that the interest determined under the objective interest index on the date of the computation will remain constant over the term of the loan. The term ''objective interest index'' has the meaning given to it in section 1275 and the regulations thereunder (relating to variable rate debt instruments). Examples of an objective interest index include the prime rate of a designated financial institution, LIBOR (London Interbank Offered Rate), and the applicable federal rate under section 1274(d).

(3) *Safe harbor.* The general rule contained in paragraph (e)(1) of this section does not apply to a partnership nonrecourse liability if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of five years or one-third of the term of the liability.

(4) *De minimis exception.* The general rule contained in paragraph (e)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent of less, guarantees the interest on a loan to that partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). An allocation of interest to the extent paid by the guarantor is not treated as a partnership item of deduction or loss subject to the 10 percent or less rule.

(f) *Examples.* The following examples illustrate the principles of paragraphs (a) through (e) of this section.

Example 1. Determining when a partner bears the economic risk of loss. A and B form a general partnership with each contributing $100 in cash. The partnership purchases an office building on leased land for $1,000 from an unrelated seller, paying $200 in cash and executing a note to the seller for the balance of $800. The note is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. The partnership agreement provides that all items are allocated equally except that tax losses are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under section 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation, the $800 liability becomes due and payable. All of the partnership's assets, including the building, are deemed to be worthless. The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial contribution	$100	$100
Loss on hypothetical sale	(900)	(100)
	($800)	$0

Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, $800 of the partnership liability is classified as a recourse liability because one or more partners bears the economic risk of loss for non-payment. B has no share of the $800 liability since the constructive liquidation produces no payment obligation for B. A's share of the partnership liability is $800 because A would have an obligation in that amount to make a contribution to the partnership.

Example 2. Recourse liability; deficit restoration obligation. C and D each contribute $500 in cash to the capital of a new general partnership, CD. CD purchases property from an unrelated seller for $1,000 in cash and a $9,000 mortgage note. The note is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. The partnership agreement provides that profits and losses are to be divided 40% to C and 60% to D. C and D are required to make up any deficit in their capital accounts. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	C	D
Initial contribution	$500	$500
Loss on hypothetical sale	(4,000) ($3,500)	(6,000) ($5,500)

C's capital account reflects a deficit that C would have to make up to $3,500 and D's capital account reflects a deficit that D would have to make up of $5,500. Therefore, the $9,000 mortgage note is a recourse liability because one or more partners bear the economic risk of loss for the liability. C's share of the recourse liability is $3,500 and D's share is $5,500.

Example 3. Guarantee by limited partner; partner deemed to satisfy obligation. E and F form a limited partnership. E, the general partner, contributes $2,000 and F, the limited partner, contributes $8,000 in cash to the partnership. The partnership agreement allocates losses 20% to E and 80% to F until F's capital account is reduced to zero, after which all losses are allocated to E. The partnership purchases depreciable property for $25,000 using its $10,000 cash and a $15,000 recourse loan from a bank. F guarantees payment of the $15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. In a constructive liquidation, the $15,000 liability becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	E	F
Initial contribution	$2,000	$8,000
Loss on hypothetical sale	(17,000)	(8,000)
	($15,000)	$0

E, as a general partner, would be obligated by operation of law to make a net contribution to the partnership of $15,000. Because E is assumed to satisfy that obligation, it is also assumed that F would not have to satisfy F's guarantee. The $15,000 mortgage is treated as a recourse liability because one or more partners bear the economic risk of loss. E's share of the liability is $15,000, and F's share is zero. This would be so even if E's net worth at the time of the determination is less than $15,000, unless the facts and circumstances indicate a plan to circumvent or avoid E's obligation to contribute to the partnership.

Example 4. Partner guarantee with right of subrogation. G, a limited partner in the GH partnership, guarantees a portion of a partnership liability. The liability is a general obligation of the partnership, *i.e.*, no partner has been relieved from personal liability. If under state law G is subrogated to the rights of the lender, G would have the right to recover the amount G paid to the recourse lender from the general partner. Therefore, G does not bear the economic risk of loss for the partnership liability.

Example 5. Bifurcation of partnership liability; guarantee of part of nonrecourse liability. A partnership borrows $10,000, secured by a mortgage on real property. The mortgage note contains an exoneration clause which provides that in the event of default, the holder's only remedy is to foreclose on the property. The holder may not look to any other partnership asset or to any partner to pay the liability. However, to induce the lender to make the loan, a partner guarantees payment of $200 of the loan principal. The exoneration clause does not apply to the partner's guarantee. If the partner paid pursuant to the guarantee, the partner would be subrogated to the rights of the lender with respect to $200 of the mortgage debt, but the partner is not otherwise entitled to reimbursement from the partnership or any partner. For purposes of section 752, $200 of the $10,000 mortgage liability is treated as a recourse liability of the partnership and $9,800 is treated as a nonrecourse liability of the partnership. The partner's share of the recourse liability of the partnership is $200.

Example 6. Wrapped debt. I, an individual, purchases real estate from an unrelated seller for $10,000, paying $1,000 in cash and giving a $9,000 purchase mortgage note on which I has no personal liability and as to which the seller can look only to the property for satisfaction. At a time when the property is worth $15,000, I sells the property to a partnership in which I is a general partner. The partnership pays for the property with a partnership purchase money mortgage note of $15,000 on which neither the partnership nor any partner (or person related to a partner) has personal liability. The $15,000 mortgage note is a wrapped debt that includes the $9,000 obligation to the original seller. The liability is a recourse liability to the extent of $6,000 because I is the creditor with respect to the loan and I bears the economic risk of loss for $6,000. I's share of the recourse liability is $6,000. The remaining $9,000 is treated as a partnership nonrecourse liability that is owed to the unrelated seller.

Example 7. Guarantee of interest by partner treated as part recourse and part nonrecourse. On January 1, 1992, a partnership obtains a $4,000,000 loan secured by a shopping center owned by the partnership. Neither the partnership nor any partner has any personal liability under the loan documents for repayment of the stated principal amount. Interest accrues at a 15 percent annual rate and is payable on December 31 of each year. The principal is payable in a lump sum on December 31, 2006. A partner guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property. When the partnership obtains the loan, the present value (discounted at 15 percent, compounded annually) of the future interest payments is $3,508,422, and of the future principal payment is $491,578. If tested on that date, the loan would be treated as a partnership liability of $1,754,211 ($3,508,422×.5) for which the guaranteeing partner bears the economic risk of loss and a partnership nonrecourse liability of $2,245,789 ($1,754,211 + $491,578).

Example 8. Contingent obligation not recognized. J and K form a general partnership with cash contributions of $2,500 each. J and K share partnership profits and losses equally. The partnership purchases an apartment building for its $5,000 of cash and a $20,000 nonrecourse loan from a commercial bank. The nonrecourse loan is secured by a mortgage on the building. The loan documents provide that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in the value of the apartment building resulting from the partnership's failure properly to maintain the property. There are no facts that establish with reasonable certainty the existence of any liability on the part of the partnership (and its partners) for damages resulting from the partnership's failure properly to maintain the building. Therefore, no partner bears the economic risk of loss, and the liability constitutes a nonrecourse liability. Under §1.752–3, J and K share this nonrecourse liability equally because they share all profits and losses equally.

(g) *Time-value-of-money considerations*—(1) *In general.* The extent to which a partner or related person bears the economic risk of loss is determined by taking into account any delay in the time when a payment or contribution obligation with respect to a partnership liability is to be satisfied. If a payment obligation with respect to a partnership liability is not required to be satisfied within a reasonable time after the liability becomes due and payable, or if the obligation to make a contribution to the partnership is not required to be satisfied before the later of—

(i) The end of the year in which the partner's interest is liquidated, or

(ii) 90 days after the liquidation,

the obligation is recognized only to the extent of the value of the obligation.

(2) *Valuation of an obligation.* The value of a payment or contribution obligation that is not required to be satisfied within the time period specified in paragraph (g)(1) of this section equals the entire principal balance of the obligation only if the obligation bears interest equal to or greater than the applicable federal rate under section 1274(d) at the time of valuation, commencing on—

(i) In the case of a payment obligation, the date that the partnership liability to a creditor or other person to whom the obligation relates becomes due and payable, or

(ii) In the case of a contribution obligation, the date of the liquidation of the partner's interest in the partnership. If the obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the value of the obligation is discounted to the present value of all payments due from the partner or related person (*i.e.*, the imputed principal amount computed under section 1274(b)). For purposes of making this present value determination, the partnership is deemed to have constructively liquidated as of the date on which the payment obligation is valued and the payment obligation is assumed to be a debt instrument subject to the rules of section 1274 (*i.e.*, the debt instrument is treated as if it were issued for property at the time of the valuation).

(3) *Satisfaction of obligation with partner's promissory note.* An obligation is not satisfied by the transfer to the obligee of a promissory note by a partner or related person unless the note is readily tradeable on an established securities market.

(4) *Example.* The following example illustrates the principle of paragraph (g) of this section.

Example. Value of obligation not required to be satisfied within specified time period. A, the general partner, and B, the limited partner, each contributes $10,000 to partnership AB. AB purchases property from an unrelated seller for $20,000 in cash and a $70,000 recourse purchase money note. The partnership agreement provides that profits and losses are to be divided equally. A and B are required to make up any deficit in their capital accounts. While A is required to restore any deficit balance in A's capital account within 90 days after the date of liquidation of the partnership, B is not required to restore any deficit for two years following the date of liquidation. The deficit in B's capital account will not bear interest during that two-year period. In a constructive liquidation, all partnership assets are deemed to become worthless and all partnership liabilities become due and payable in full. The partnership is deemed to dispose of all its assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial contribution	$10,000	$10,000
Loss on hypothetical sale	(45,000)	(45,000)
	(35,000)	(35,000)

A's and B's capital accounts each reflect deficits of $35,000. B's obligation to make a contribution pursuant to B's deficit restoration obligation is recognized only to the extent of the fair market value of that obligation at the time of the constructive liquidation because B is not required to satisfy that obligation by the later of the end of the partnership taxable year in which B's interest is liquidated or within 90 days after the date of the liquidation. Because B's obligation does not bear interest, the fair market value is deemed to equal the imputed principal amount under section 1274(b). Under section 1274(b), the imputed principal amount of a debt instrument equals the present value of all payments due under the debt instrument. Assume the applicable federal rate with respect to B's obligation is 10 percent compounded semiannually. Using this discount rate, the present value of the $35,000 payment that B would be required to make two years after the constructive liquidation to restore the deficit balance in B's capital account equals $28,795. To the extent that B's deficit restoration obligation is not recognized, it is assumed that B's obligation does not exist. Therefore, A, as the sole general partner, would be obligated by operation of law to contribute an additional $6,205 of capital to the partnership. Accordingly, under paragraph (g) of this section, B bears the economic risk of loss for $28,795 and A bears the economic risk of loss for $41,205 ($35,000 + $6,205).

(h) *Partner providing property as security for partnership liability*—(1) *Direct pledge.* A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any the partner's or related person's separate property (other than a direct or indirect interest in the partnership) that is pledged as security for the partnership liability.

(2) *Indirect pledge.* A partner is considered to bear the economic risk of loss for a partnership liability to the extent of the value of any property that the partner contributes to the partnership solely for the purpose of securing a partnership liability. Contributed property is not treated as contributed solely for the purpose of securing a partnership liability unless substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction.

(3) *Valuation.* The extent to which a partner bears the economic risk of loss as a result of a direct pledge described in paragraph (h)(1) of this section or an indirect pledge described in paragraph (h)(2) of this section is limited to the fair market value of the property at the time of the pledge or contribution.

(4) *Partner's promissory note.* For purposes of paragraph (h)(2) of this section, a promissory note of the partner or related person that is contributed to the partnership shall not be taken into account unless the note is readily

tradeable on an established securities market.

(i) *Treatment of recourse liabilities in tiered partnerships.* If a partnership (the ''upper-tier partnership'') owns (directly or indirectly through one or more partnerships) an interest in another partnership (the ''lower-tier partnership''), the liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of the following—

(1) The amount of the economic risk of loss that the upper-tier partnership bears with respect to the liabilities; and

(2) Any other amount of the liabilities with respect to which partners of the upper-tier partnership bear the economic risk of loss.

(j) *Anti-abuse rules*—(1) *In general.* An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.

(2) *Arrangements tantamount to a guarantee.* Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that:

(i) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;

(ii) The contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(iii) One of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

The partners are considered to bear the economic risk of loss for the liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership which is not on commercially reasonable terms may be tantamount to a guarantee by the partner of a partnership liability.

(3) *Plan to circumvent or avoid the obligation.* An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

(4) *Example.* The following example illustrates the principle of paragraph (j)(3) of this section.

Example. Plan to circumvent or avoid obligation. A and B form a general partnership. A, a corporation, contributes $20,000 and B contributes $80,000 to the partnership. A is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to A and 80% to B until B's capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a $150,000 recourse loan from a bank. B guarantees payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary, formed by a parent of a consolidated group, with capital limited to $20,000 to allow the consolidated group to enjoy the tax losses generated by the property while at the same time limiting its monetary exposure for such losses. These facts, when considered together with B's guarantee, indicate a plan to circumvent or avoid A's obligation to contribute to the partnership. The rules of section 752 must be applied as if A's obligation to contribute did not exist. Accordingly, the $150,000 liability is a recourse liability that is allocated entirely to B.

[T.D. 8380, 56 FR 66351, Dec. 23, 1991; 57 FR 4913, Feb. 10, 1992; 57 FR 5054, Feb. 12, 1992; 57 FR 5511, Feb. 14, 1992]

§ 1.752–3 Partner's share of nonrecourse liabilities.

(a) *In general.* A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows—

(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under §1.704–3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in §1.704–3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. This additional method does not apply for purposes of §1.707–5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

(b) *Allocation of a single nonrecourse liability among multiple properties*—(1) *In general.* For purposes of determining the amount of taxable gain under paragraph (a)(2) of this section, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method. A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.

(2) *Reductions in principal.* For purposes of this paragraph (b), when the outstanding principal of a partnership liability is reduced, the reduction of outstanding principal is allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties under paragraph (b)(1) of this section.

(c) *Examples.* The following examples illustrate the principles of this section:

Example 1. Partner's share of nonrecourse liabilities. The AB partnership purchases depreciable property for a $1,000 purchase money note that is nonrecourse liability under the rules of this section. Assume that this is the only nonrecourse liability of the partnership, and that no principal payments are due on the purchase money note for a year. The partnership agreement provides that all items of income, gain, loss, and deduction are allocated equally. Immediately after purchasing the depreciable property, the partners share the nonrecourse liability equally because they have equal interests in partnership profits. A and B are each treated as if they contributed $500 to the partnership to reflect each partner's increase in his or her share of partnership liabilities (from $0 to $500). The minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of gain that would be recognized if the partnership disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. Therefore, if the partnership claims a depreciation deduction of $200 for the depreciable property for the year it acquires that property, partnership minimum gain for the year will increase by $200 (the excess of the $1,000 nonrecourse liability over the $800 adjusted tax basis of the property). See section 704(b) and the regulations thereunder. A and B each have a $100 share of partnership minimum gain at the end of that year because the depreciation deduction is treated as a nonrecourse deduction. See section 704(b) and the regulation thereunder. Accordingly, at the end of that year, A and B are allocated $100 each of the nonrecourse liability to match their shares of partnership minimum gain. The remaining $800 of the nonrecourse liability will be allocated equally between A and B ($400 each).

Example 2. Excess nonrecourse liabilities allocated consistently with reasonably expected deductions. The facts are the same as in *Example 1* except that the partnership agreement provides that depreciation deductions will be allocated to A. The partners agree to allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Assuming that the allocation of all of the depreciation deductions to A is valid under section 704(b), immediately after purchasing the depreciable property, A's share of the nonrecourse liability is $1,000. Accordingly, A is treated as if A contributed $1,000 to the partnership.

Example 3. Allocation of liability among multiple properties. (i) A and B are equal partners in a partnership (PRS). A contributes $70 of cash in exchange for a 50-percent interest in PRS. B contributes two items of property, X and Y, in exchange for a 50-percent interest in PRS. Property X has a fair market value (and book value) of $70 and an adjusted basis of $40, and is subject to a nonrecourse liability of $50. Property Y has a fair market value (and book value) of $120, an adjusted basis of $40, and is subject to a nonrecourse liability of $70. Immediately after the initial contributions, PRS refinances the two separate liabilities with a single $120 nonrecourse liability. All of the built-in gain attributable to Property X ($30) and Property Y ($80) is section 704(c) gain allocable to B.

(ii) The amount of the nonrecourse liability ($120) is less than the total book value of all of the properties that are subject to such liability ($70 + $120 = $190), so there is no partnership minimum gain. §1.704–2(d). Accordingly, no portion of the liability is allocated pursuant to paragraph (a)(1) of this section.

(iii) Pursuant to paragraph (b)(1) of this section, PRS decides to allocate the nonrecourse liability evenly between the Properties X and Y. Accordingly, each of Properties X and Y are treated as being subject to a separate $60 nonrecourse liability for purposes of applying paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B will be allocated $20 of the liability for each of Properties X and Y (in each case, $60 liability minus $40 adjusted basis). As a result, a portion of the liability is allocated pursuant to paragraph (a)(2) of this section as follows:

Partner	Property	Tier 1	Tier 2
A	X	$0	$0
	Y	0	0
B	X	0	20
	Y	0	20

(iv) PRS has $80 of excess nonrecourse liability that it may allocate in any manner consistent with paragraph (a)(3) of this section. PRS determines to allocate the $80 of excess nonrecourse liabilities to the partners up to their share of the remaining section 704(c) gain on the properties, with any remaining amount of liabilities being allocated equally to A and B consistent with their equal interests in partnership profits. B has $70 of remaining section 704(c) gain ($10 on Property X and $60 on Property Y), and thus will be allocated $70 of the liability in accordance with this gain.

The remaining $10 is divided equally between A and B. Accordingly, the overall allocation of the $120 nonrecourse liability is as follows:

Partner	Tier 1	Tier 2	Tier 3	Total
A	$0	$0	$5	$5
B	0	40	75	115

[T.D. 8380, 56 FR 66355, Dec. 23, 1991, as amended by T.D. 8906, 65 FR 64890, Oct. 31, 2000]

§ 1.752–4 Special rules.

(a) *Tiered partnerships.* An upper-tier partnership's share of the liabilities of a lower-tier partnership (other than any liability of the lower-tier partnership that is owed to the upper-tier partnership) is treated as a liability of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.

(b) *Related person definition*—(1) *In general.* A person is related to a partner if the person and the partner bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the following modifications:

(i) Substitute ''80 percent or more'' for ''more than 50 percent'' each place it appears in those sections;

(ii) A person's family is determined by excluding brothers and sisters; and

(iii) Disregard sections 267(e)(1) and 267(f)(1)(A).

(2) *Person related to more than one partner*—(i) *In general.* If, in applying the related person rules in paragraph (b)(1) of this section, a person is related to more than one partner, paragraph (b)(1) of this section is applied by treating the person as related only to the partner with whom there is the highest percentage of related ownership. If two or more partners have the same percentage of related ownership and no other partner has a greater percentage, the liability is allocated equally among the partners having the equal percentages of related ownership.

(ii) *Natural persons.* For purposes of determining the percentage of related ownership between a person and a partner, natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent with respect to each other.

(iii) *Related partner exception.* Notwithstanding paragraph (b)(1) of this section (which defines related person), persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership. This paragraph (iii) does not apply when determining a partner's interest under the de minimis rules in §§ 1.752–2 (d) and (e).

(iv) *Special rule where entity structured to avoid related person status*—(A) *In general.* If—

(*1*) A partnership liability is owed to or guaranteed by another entity that is a partnership, an S corporation, a C corporation, or a trust;

(*2*) A partner or related person owns (directly or indirectly) a 20 percent or more ownership interest in the other entity; and

(*3*) A principal purpose of having the other entity act as a lender or guarantor of the liability was to avoid the determination that the partner that owns the interest bears the economic risk of loss for federal income tax purposes for all or part of the liability;

then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity.

(B) *Ownership interest.* For purposes of paragraph (b)(2)(iv)(A) of this section, a person's ownership interest in:

(*1*) A partnership equals the partner's highest percentage interest in any item of partnership loss or deduction for any taxable year;

(*2*) An S corporation equals the percentage of the outstanding stock in the S corporation owned by the shareholder;

(*3*) A C corporation equals the percentage of the fair market value of the issued and outstanding stock owned by the shareholder; and

(*4*) A trust equals the percentage of the actuarial interests owned by the beneficial owner of the trust.

(C) Example. Entity structured to avoid related person status. A, B, and C form a general partnership, ABC. A, B, and C are equal partners, each contributing $1,000 to the partnership. A and B want to loan money to ABC and have the loan treated as nonrecourse for purposes of section 752. A and B form partnership AB to which each contributes $50,000. A and B share losses equally in partnership AB. Partnership AB loans partnership ABC $100,000 on a nonrecourse basis secured by the property ABC buys with the loan. Under these facts and circumstances, A and B bear the economic risk of loss with respect to the partnership liability equally based on their percentage interest in losses of partnership AB.

(c) *Limitation.* The amount of an indebtedness is taken into account only once, even though a partner (in addition to the partner's liability for the indebtedness as a partner) may be separately liable therefor in a capacity other than as a partner.

(d) *Time of determination.* A partner's share of partnership liabilities must be determined whenever the determination is necessary in order to determine the tax liability of the partner or any other person. See § 1.705–1(a) for rules regarding when the adjusted basis of a partner's interest in the partnership must be determined.

[T.D. 8380, 56 FR 66356, Dec. 23, 1991]

§ 1.752–5 Effective dates and transition rules.

(a) *In general.* Unless a partnership makes an election under paragraph (b)(1) of this section to apply the provisions of §§ 1.752–1 through 1.752–4 earlier, §§ 1.752–1 through 1.752–4 apply to any liability incurred or assumed by a partnership on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. However, § 1.752–3(a)(3) fifth, sixth, and seventh sentences, (b), and (c) *Example 3,* do not apply to any liability incurred or assumed by a partnership prior to October 31, 2000. Nevertheless, § 1.752–3(a)(3) fifth, sixth, and seventh sentences, (b), and (c) *Example 3,* may be relied upon for any liability incurred or assumed by a partnership prior to October 31, 2000 for taxable years ending on or after October 31, 2000. In addition, § 1.752–1(f) last sentence and (g) *Example 2,* do not apply to any liability incurred or assumed by a partnership prior to January 4, 2001. Nevertheless, § 1.752–1(f) last sentence and (g) *Example 2,* may be relied on for any liability incurred or assumed by a partnership prior to January 4, 2001 and, unless the partnership makes an election under paragraph (b)(1) of this section, on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. For liabilities incurred or assumed by a partnership prior to December 28, 1991 (or pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter), unless an election to apply these regulations has been made, see §§ 1.752–0T to 1.752–4T, set forth in 26 CFR 1.752–0T through 1.752–4T as contained in 26 CFR edition revised April 1, 1991, (TD 8237, TD 8274, and TD 8355) and § 1.752–1, set forth in 26 CFR 1.752–1 as contained in 26 CFR edition revised April 1, 1988 (TD 6175 and TD 6500).

(b) *Election*—(1) *In general.* A partnership may elect to apply the provisions of §§ 1.752–1 through 1.752–4 to all of its liabilities to which the provisions of those sections do not otherwise apply as of the beginning of the first taxable year of the partnership ending on or after December 28, 1991.

(2) *Time and manner of election.* An election under this paragraph (b) is made by attaching a written statement to the partnership return for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and contain a declaration that an election is being made under this paragraph (b).

(c) *Effect of section 708(b)(1)(B) termination on determining date liabilities are incurred or assumed.* For purposes of applying this section, a termination of the partnership under section 708(b)(1)(B) will not cause partnership liabilities incurred or assumed prior to the termination to be treated as incurred or assumed on the date of the termination.

[T.D. 8380, 56 FR 66356, Dec. 23, 1991, as amended by T.D. 8906, 65 FR 64890, Oct. 31, 2000; T.D. 8925, 66 FR 723, Jan. 4, 2001]

1.752–6T Partnership assumption of partner's section 358(h)(3) liability after October 18, 1999, and before June 24, 2003 (temporary).

(a) *In general.* If, in a transaction described in section 721(a), a partnership assumes a liability (defined in section 358(h)(3)) of a partner (other than a liability to which section 752(a) and (b) apply), then, after application of section 752(a) and (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. For purposes of this section, the adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under §§ 1.752–1 through 1.752–5.

(b) *Exceptions*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, the exceptions contained in section 358(h)(2)(A) and (B) apply to this section.

(2) *Transactions described in Notice 2000–44.* The exception contained in section 358(h)(2)(B) does not apply to an assumption of a liability (defined in section 358(h)(3)) by a partnership as part of a transaction described in, or a transaction that is substantially similar to the transactions described in, Notice 2000–44 (2000–2 C.B. 255). See § 601.601(d)(2) of this chapter.

(c) *Example.* The following example illustrates the principles of paragraph (a) of this section:

Example. In 1999, A and B form partnership PRS. A contributes property with a value and basis of $200, subject to a nonrecourse debt obligation of $50 and a fixed or contingent obligation of $100 that is not a liability to which section 752(a) and (b) applies, in exchange for a 50% interest in PRS. Assume that, after the contribution, A's share of partnership liabilities under §§ 1.752–1 through 1.752–5 is $25. Also assume that the $100 liability is not associated with a trade or business contributed by A to PRS or with assets contributed by A to PRS. After the contribution, A's basis in PRS is $175 (A's basis in the contributed land ($200) reduced by the nonrecourse debt assumed by PRS ($50), increased by A's share of partnership liabilities under §§ 1.752–1 through 1.752–5 ($25)). Because A's basis in the PRS interest is greater than the adjusted value of A's interest, $75 (the fair market value of A's interest ($50) increased by A's share of partnership liabilities ($25)), paragraph (a) of this section operates to reduce A's basis in the PRS interest (but not below the adjusted value of that interest) by the amount of liabilities described in section 358(h)(3) (other than liabilities to which section 752(a) and (b) apply) assumed by PRS. Therefore, A's basis in PRS is reduced to $75.

(d) *Effective dates*—(1) *In general.* This section applies to assumptions of liabilities occurring after October 18, 1999 and before June 24, 2003.

(2) *Election to apply § 1.752–7.* The partnership may elect, under provisions of REG–106736–00 in 2003–28 I.R.B. (*see* § 601.601(d)(2) of this chapter) to apply those provisions and related Income Tax Regulations to all assumptions of liabilities by the partnership occurring after October 18, 1999, and before June 24, 2003. Provisions of REG–106736–00 in 2003–28 I.R.B. (*see* § 601.601(d)(2) of this chapter) describe the manner in which the election is made.

[T.D. 9062, 68 FR 37416, June 24, 2003]

§ 1.753–1 Partner receiving income in respect of decedent.

(a) *Income in respect of a decedent under section 736(a).* All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

(b) *Other income in respect of a decedent.* When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes. See paragraph (c) (3) of § 1.706–1.

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

Example. A and the decedent B were equal partners in a business having assets (other than money) worth $40,000 with an adjusted basis of $10,000. Certain partnership business was well advanced towards completion before B's death and, after B's death but before the end of the partnership year, payment of

$10,000 was made to the partnership for such work. The partnership agreement provided that, upon the death of one of the partners, all partnership property, including unfinished work, would pass to the surviving partner, and that the surviving partner would pay the estate of the decedent the undrawn balance of his share of partnership earnings to the date of death, plus $10,000 in each of the three years after death. B's share of earnings to the date of his death was $4,000, of which he had withdrawn $3,000. B's distributive share of partnership income of $4,000 to the date of his death is income in respect of a decedent (although only the $1,000 undrawn at B's death will be reflected in the value of B's partnership interest on B's estate tax return). Assume that the value of B's interest in partnership property at the date of his death was $22,000, composed of the following items: B's one-half share of the assets of $40,000, plus $2,000, B's interest in partnership cash. It should be noted that B's $1,000 undrawn share of earnings to the date of his death is not a separate item but will be paid from partnership assets. Under the partnership agreement, A is to pay B's estate a total of $31,000. The difference of $9,000 between the amount to be paid by A ($31,000) and the value of B's interest in partnership property ($22,000) comes within section 736(a) and, thus, also constitutes income in respect of a decedent. (However, the $17,000 difference between the $5,000 basis for B's share of the partnership property and its $22,000 value at the date of his death does not constitute income in respect of a decedent.) If, before the close of the partnership taxable year, A pays B's estate $11,000, of which they agree to allocate $3,000 as the payment under section 736(a), B's estate will include $7,000 in its gross income (B's $4,000 distributive share plus $3,000 payment under section 736(a)). In computing the deduction under section 691(c), this $7,000 will be considered as the value for estate tax purposes of such income in respect of a decedent, even though only $4,000 ($1,000 of distributive share not withdrawn, plus $3,000, payment under section 736(a)) of this amount can be identified on the estate tax return as part of the partnership interest.

(d) *Effective date.* The provisions of section 753 apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954. See section 771(b)(4) and paragraph (b)(4) of § 1.771–1.

§ 1.754–1 Time and manner of making election to adjust basis of partnership property.

(a) *In general.* A partnership may adjust the basis of partnership property under sections 734(b) and 743(b) if it files an election in accordance with the rules set forth in paragraph (b) of this section. An election may not be filed to make the adjustments provided in either section 734(b) or section 743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section shall apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to paragraph (c) of this section.

(b) *Time and method of making election.* (1) An election under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of § 1.6031–1 (including extensions thereof) for filing the return for such taxable year (or before August 23, 1956, whichever is later). Notwithstanding the preceding two sentences, if a valid election has been made under section 754 and this section for a preceding taxable year and not revoked pursuant to paragraph (c) of this section, a new election is not required to be made. The statement required by this subparagraph shall (i) set forth the name and address of the partnership making the election, (ii) be signed by any one of the partners, and (iii) contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b). For rules regarding extensions of time for filing elections, see § 1.9100–1.

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

Example. A, a U.S. citizen, is a member of partnership ABC, which has not previously made an election under section 754 to adjust the basis of partnership property. The partnership and the partners use the calendar year as the taxable year. A sells his interest in the partnership to D on January 1, 1971. The partnership may elect under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b). Unless an extension of time to make the election is obtained under the provisions of § 1.9100–1, the election must be made in a written statement filed with the partnership return for 1971 and must contain the information specified in subparagraph (1) of this paragraph. Such return must be filed by April 17, 1972 (unless an extension of time for filing the return is obtained). The election will apply to all distributions of property to a partner and transfers of an interest in the partnership occurring in 1971 and subsequent years, unless revoked pursuant to paragraph (c) of this section.

(c) *Revocation of election.* (1) *In general.* A partnership having an election in effect under this section may revoke such election with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. A partnership which wishes to revoke such an election shall file with the district director for the internal revenue district in which the partnership return is required to be filed an application setting forth the grounds on which the revocation is desired. The application shall be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and shall be signed by any one of the partners. Examples of situations which may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. However, no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

(2) *Revocations effective on December 15, 1999.* Notwithstanding paragraph (c)(1) of this section, any partnership having an election in effect under this section for its taxable year that includes December 15, 1999, may revoke such election effective for transfers or distributions occurring on or after December 15, 1999, by attaching a statement to the partnership's return for such year. For the revocation to be valid, the statement must be filed not later than the time prescribed by § 1.6031(a)-1(e) (including extensions thereof) for filing the return for such taxable year, and must set forth the name and address of the partnership revoking the election, be signed by any one of the partners who is authorized to sign the partnership's federal income tax return, and contain a declaration that the partnership revokes its election under section 754 to apply the provisions of section 734(b) and 743(b). In addition, the following statement must be prominently displayed in capital letters on the first page of the partnership's return for such year: ''RETURN FILED PURSUANT TO § 1.754–1(c)(2).''

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972; T.D. 8847, 64 FR 69916, Dec. 15, 1999; 65 FR 9220, Feb. 24, 2000]

§ 1.755–1 Rules for allocation of basis.

(a) *In general*—(1) *Scope.* This section provides rules for allocating basis adjustments under sections 743(b) and 734(b) among partnership property. If there is a basis adjustment to which this section applies, the basis adjustment is allocated among the partnership's assets as follows. First, the partnership must determine the value of each of its assets under paragraphs (a)(2) through (5) of this section. Second, the basis adjustment is allocated between the two classes of property described in section 755(b). These classes of property consist of capital assets and section 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property. Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class. Basis adjustments under section 743(b) are allocated among partnership assets under paragraph (b) of this section. Basis adjustments under section 734(b) are allocated among partnership assets under paragraph (c) of this section.

(2) *Coordination of sections 755 and 1060.* If there is a basis adjustment to which this section applies, and the assets of the partnership constitute a trade or business (as described in § 1.1060–1(b)(2)), then the partnership is required to use the residual method to assign values to the partnership's section 197 intangibles. To do so, the partnership must, first, determine the value of partnership assets other than section 197 intangibles under paragraph (a)(3) of this section. The partnership then must determine partnership gross value under paragraph (a)(4) of this section. Last, the partnership must assign values to the partnership's section 197 intangibles under paragraph (a)(5) of this section. For purposes of this section, the term *section 197 intangibles* includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

(3) *Values of properties other than section 197 intangibles.* For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

(4) *Partnership gross value*—(i) *Basis adjustments under section 743(b)*—(A) *In general.* Except as provided in paragraph (a)(4)(ii) of this section, in the case of a basis adjustment under section 743(b), partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).

(B) *Special situations.* In certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles held by the partnership. In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

(C) *Income in respect of a decedent.* Solely for the purpose of determining partnership gross value under this paragraph (a)(4)(i), where a partnership interest is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to section 1014(c), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691.

(ii) *Basis adjustments under section 743(b) resulting from substituted basis transactions.* This paragraph (a)(4)(ii) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

(iii) *Basis adjustments under section 734(b).* In the case of a basis adjustment under section 734(b), partnership gross value equals the value of the entire partnership as a going concern immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution.

(5) *Determining the values of section 197 intangibles*—(i) *Two classes.* If the aggregate value of partnership property other than section 197 intangibles (as determined in paragraph (a)(3) of this section) is equal to or greater than partnership gross value (as determined in paragraph (a)(4) of this section), then all section 197 intangibles are deemed to have a value of zero for purposes of this section. In all other cases, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles. The residual section 197 intangibles value must be allocated between two asset classes in the following order—

(A) Among section 197 intangibles other than goodwill and going concern value; and

(B) To goodwill and going concern value.

(ii) *Values assigned to section 197 intangibles other than goodwill and going concern value.* The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the extent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

(iii) *Value assigned to goodwill and going concern value.* The fair market value of goodwill and going concern value is the amount, if any, by which the residual section 197 intangibles value exceeds the aggregate value of the partnership's section 197 intangibles (other than goodwill and going concern value).

(6) *Examples.* The provisions of paragraphs (a)(2) through (5) are illustrated by the following examples, which assume that the partnerships have an election in effect under section 754 at the time of the transfer and that the assets of each partnership constitute a trade or business (as described in § 1.1060–1(b)(2)). Except as provided, no partnership asset (other than inventory) is property described in section 751(a), and partnership liabilities are secured by all partnership assets. The examples are as follows:

Example 1. (i) A is the sole general partner in PRS, a limited partnership having three equal partners. PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two other assets with fair market values (determined using all the facts and circumstances) as follows: inventory worth $1,000,000 and a building (a capital asset) worth $2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is $50,000. PRS has one liability of $1,000,000, for which A bears the entire risk of loss under section 752 and the regulations thereunder. D purchases A's partnership interest for $650,000, resulting in a basis adjustment under section 743(b). After the purchase, D bears the entire risk of loss for PRS's liability under section 752 and the regulations thereunder. Therefore, D's basis in its interest in PRS is $1,650,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $650,000 ($1,650,000—$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $2,950,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $650,000).

(iii) Under paragraph (a)(3) of this section, the inventory has a fair market value of $1,000,000, and the building has a fair market value of $2,000,000. Thus, the aggregate value of partnership property other than section 197 intangibles, $3,000,000, is equal to or greater than partnership gross value, $2,950,000. Accordingly, under paragraphs (a)(3) and (5) of this section, the value assigned to each of the partnership's assets is as follows: inventory, $1,000,000; building, $2,000,000; Intangibles 1 and 2, $0; and goodwill and going concern value, $0. D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 2. (i) Assume the same facts as in *Example 1*, except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that D purchases A's interest in PRS for $1,000,000. After the purchase, D's basis in its interest in PRS is $2,000,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $1,000,000 ($2,000,000—$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $4,000,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $1,000,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $1,000,000 (the excess of partnership gross value, $4,000,000, over the aggregate value of assets other than section 197 intangibles, $3,000,000 (the sum of the value of the inventory, $1,000,000, and the value of the building, $2,000,000)). The partnership must determine the values of section 197 assets by allocating the residual section 197 intangibles value among the partnership's assets. The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 3. (i) Assume the same facts as in *Example 1*, except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that D purchases A's interest in PRS for $750,000. After the purchase, D's basis in its interest in PRS is $1,750,000. Also assume that Intangible 1 was originally purchased for $300,000, and that its adjusted basis has been decreased to $50,000 as a result of amortization. Assume that, if PRS were to sell Intangible 1 for $300,000, it would recognize $250,000 of gain that would be treated as an unrealized receivable under the flush language in section 751(c).

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $750,000 ($1,750,000—$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $3,250,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $750,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $250,000 (the amount by which partnership gross value, $3,250,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $3,000,000). Intangible 1 has potential gain that would be treated as unrealized receivables under the flush language of section 751(c). The flush language receivables value in Intangible 1 is $300,000 (the sum of PRS's basis in Intangible 1, $50,000, and the amount of ordinary income, $250,000, that the partnership would recognize if Intangible 1 were sold for its actual fair market value). Because the residual section 197 intangibles value, $250,000, is less than the flush language receivables value of Intangible 1, Intangible 1 is assigned a value of $250,000, and Intangible 2 and goodwill and going concern value are assigned a value of zero. D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example 4. Assume the same facts as in *Example 1*, except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that A does not sell its interest in PRS. Instead, A contributes its interest in PRS to E, a newly formed corporation wholly-owned by A, in a transaction described in section 351. Assume that the contribution results in a basis adjustment under section 743(b) (other than zero). PRS determines that its value as a going concern immediately following the contribution is $3,000,000. Under paragraph (a)(4)(ii) of this section, partnership gross value is $4,000,000 (the value of PRS as a going concern, $3,000,000, increased by the partnership's liability, $1,000,000, immediately after the contribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $1,000,000 (the amount by which partnership gross value, $4,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $3,000,000). Of the residual section 197 intangibles value, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). E's section 743(b) adjustment must be allocated under paragraph (b)(5) of this section using these assigned fair market values.

Example 5. G is the sole general partner in PRS, a limited partnership having three equal partners (G, H, and I). PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two capital assets with fair market values (determined using all the facts and circumstances) as follows: Vacant land worth $1,000,000, and a building worth $2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is $300,000. PRS has one liability of $1,000,000, for which G bears the entire risk of loss under section 752 and the regulations thereunder. PRS distributes the land to H in liquidation of H's interest in PRS. Immediately prior to the distribution, PRS's basis in the land is $800,000, and H's basis in its interest in PRS is $750,000. The distribution causes the partnership to increase the basis of its remaining property by $50,000 under section 734(b)(1)(B). PRS determines that its value as a going concern immediately following the distribution is $2,000,000. Under paragraph (a)(4)(iii) of this section, partnership gross value is $3,000,000 (the value of PRS as a going concern, $2,000,000, increased by the partnership's liability, $1,000,000, immediately after the distribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value of PRS's section 197 intangibles is $1,000,000 (the amount by which partnership gross value, $3,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $2,000,000). Of the residual section 197 intangibles value, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). PRS's section 734(b) adjustment must be allocated under paragraph (c) of this section using these assigned fair market values.

(b) *Adjustments under section 743(b)*—(1) *Generally.* (i) *Application.* For basis adjustments under section 743(b) resulting from substituted basis transactions, paragraph (b)(5) of this section shall apply. For basis adjustments under section 743(b) resulting from all other transfers, paragraphs (b)(2) through (4) of this section shall apply. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

(ii) *Hypothetical transaction.* For purposes of paragraphs (b)(2) through (b)(4) of this section, the allocation of the basis adjustment under section 743(b) between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss (including remedial allocations under § 1.704–3(d)) that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the hypothetical transaction).

(2) *Allocations between classes of property*—(i) *In general.* The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction. The amount of

the basis adjustment to capital gain property is equal to—

(A) The total amount of the basis adjustment under section 743(b); less

(B) The amount of the basis adjustment allocated to ordinary income property under the preceding sentence; provided, however, that in no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under § 1.704–3(d) from the hypothetical transaction) in capital gain property. In the event that a decrease in basis allocated to capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.

(ii) *Examples.* The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example 1. (i) A and B form equal partnership PRS. A contributes $50,000 and Asset 1, a nondepreciable capital asset with a fair market value of $50,000 and an adjusted tax basis of $25,000. B contributes $100,000. PRS uses the cash to purchase Assets 2, 3, and 4. After a year, A sells its interest in PRS to T for $120,000. At the time of the transfer, A's share of the partnership's basis in partnership assets is $75,000. Therefore, T receives a $45,000 basis adjustment.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	Fair market value
Capital Gain Property:		
Asset 1	$25,000	$75,000
Asset 2	100,000	117,500
Ordinary Income Property:		
Asset 3	40,000	45,000
Asset 4	10,000	2,500
Total	175,000	240,000

(iii) If PRS sold all of its assets in a fully taxable transaction at fair market value immediately after the transfer of the partnership interest to T, the total amount of capital gain that would be allocated to T is equal to $46,250 ($25,000 section 704(c) built-in gain from Asset 1, plus fifty percent of the $42,500 appreciation in capital gain property). T would also be allocated a $1,250 ordinary loss from the sale of the ordinary income property.

(iv) The amount of the basis adjustment that is allocated to ordinary income property is equal to ($1,250) (the amount of the loss allocated to T from the hypothetical sale of the ordinary income property).

(v) The amount of the basis adjustment that is allocated to capital gain property is equal to $46,250 (the amount of the basis adjustment, $45,000, less ($1,250), the amount of loss allocated to T from the hypothetical sale of the ordinary income property).

Example 2 . (i) A and B form equal partnership PRS. A and B each contribute $1,000 cash which the partnership uses to purchase Assets 1, 2, 3, and 4. After a year, A sells its partnership interest to T for $1,000. T's basis adjustment under section 743(b) is zero.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	Fair market value
Capital Gain Property:		
Asset 1	$500	$750
Asset 2	500	500
Ordinary Income Property:		
Asset 3	500	250
Asset 4	500	500
Total	2,000	2,000

(iii) If, immediately after the transfer of the partnership interest to T, PRS sold all of its assets in a fully taxable transaction at fair market value, T would be allocated a loss of $125 from the sale of the ordinary income property. Thus, the amount of the basis adjustment to ordinary income property is ($125). The amount of the basis adjustment to capital gain property is $125 (zero, the amount of the basis adjustment under section 743(b), less ($125), the amount of the basis adjustment allocated to ordinary income property).

(3) *Allocation within the class*—(i) *Ordinary income property*. The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; reduced by

(B) The product of—

(*1*) Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to the last sentence of paragraph (b)(2)(i) of this section; multiplied by

(*2*) A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

(ii) *Capital gain property*. The amount of the basis adjustment to each item of property within the class of capital gain property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; minus

(B) The product of—

(*1*) The total amount of gain or loss (including any remedial allocations under § 1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

(*2*) A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

(iii) *Special rules*—(A) *Assets in which partner has no interest*. An asset with respect to which the transferee partner has no interest in income, gain, losses, or deductions shall not be taken into account in applying paragraph (b)(3)(ii)(B) of this section.

(B) *Limitation in decrease of basis*. In no event may the amount of any decrease in basis allocated to an item of capital gain property under paragraph (b)(3)(ii)(B) of this section exceed the partnership's adjusted basis in that item (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under § 1.704–3(d) from the hypothetical transaction). In the event that a decrease in basis allocated under paragraph (b)(3)(ii)(B) of this section to an item of capital gain property would otherwise exceed the partnership's adjusted basis in that item, the excess must be applied to reduce the remaining basis, if any, of other capital gain assets pro rata in proportion to the bases of such assets (as adjusted under this paragraph (b)(3)).

(iv) *Examples*. The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section. Of the $45,000 basis adjustment, $46,250 was allocated to capital gain property. The amount allocated to ordinary income property was ($1,250).

(ii) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 1 is $37,500.

(iii) Asset 2 is a capital gain asset, and T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 2 is $8,750.

(iv) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(v) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

Example 2. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section, except that A sold its interest in PRS to T for $110,000 rather than $120,000. T, therefore, receives a basis adjustment under section 743(b) of $35,000. Of the $35,000 basis adjustment, ($1,250) is allocated to ordinary income property, and $36,250 is allocated to capital gain property.

(ii) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(iii) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

(iv) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Asset 2 is a capital gain asset, and T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. The total amount of gain that would be allocated to T from the sale of the capital gain assets in the hypothetical transaction is $46,250, which exceeds the amount of the basis adjustment allocated to capital gain property by $10,000. The amount of the adjustment to Asset 1 is $33,604 ($37,500 minus $3,896 ($10,000×$75,000/$192,500)). The amount of the basis adjustment to Asset 2 is $2,646 ($8,750 minus $6,104 ($10,000×$117,500/$192,500)).

(4) *Income in respect of a decedent*—(i) *In general.* Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691. See §1.742–1. Accordingly, if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis adjustment under section 743(b) is allocated to these assets. See §1.743–1(b).

(ii) The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) A and B are equal partners in personal service partnership PRS. In 2004, as a result of B's death, B's partnership interest is transferred to T when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows (based on all the facts and circumstances):

ASSETS

	Adjusted basis	Fair market value
Section 197 Intangible	$2,000	$5,000
Unrealized Receivables	0	15,000
Total	$2,000	$20,000

Liabilities and Capital

	Adjusted per books	Fair market value
Capital:		
A	1,000	10,000
B	1,000	10,000
Total	$2,000	$20,000

(ii) None of the assets owned by PRS is section 704(c) property, and the section 197 intangible is not amortizable. The fair market value of T's partnership interest on the applicable date of valuation set forth in section 1014 is $10,000. Of this amount, $2,500 is attributable to T's 50% share of the partnership's section 197 intangible, and $7,500 is attributable to T's 50% share of the partnership's unrealized receivables. The partnership's unrealized receivables represent income in respect of a decedent. Accordingly, under section 1014(c), T's basis in its partnership interest is not adjusted for that portion of the interest which is attributable to the unrealized receivables. Therefore, T's basis in its partnership interest is $2,500.

(iii) Under paragraph (a)(4)(i)(C) of this section, solely for purposes of determining partnership gross value, T's basis in its partnership interest is deemed to be $10,000. Under paragraph (a)(4)(i) of this section, partnership gross value is $20,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to T equal to $10,000).

(iv) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $5,000 (the excess of partnership gross value, $20,000, over the aggregate value of assets other than section 197 intangibles, $15,000). The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, $5,000 is assigned to the section 197 intangible, and $0 is assigned to goodwill and going concern value. T's section 743(b) adjustment must be allocated using these assigned fair market values.

(v) At the time of the transfer, B's share of the partnership's basis in partnership assets is $1,000. Accordingly, T receives a $1,500 basis adjustment under section 743(b). Under this paragraph (b)(4), the entire basis adjustment is allocated to the partnership's section 197 intangible.

(5) *Substituted basis transactions*—(i) *In general.* This paragraph (b)(5) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest. For exchanges on or after June 9, 2003, this paragraph (b)(5) also applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee. For example, this paragraph (b)(5) applies if a partnership interest is contributed to a corporation in a transaction to which section 351 applies, if a partnership interest is contributed to a partnership in a transaction to which section 721(a) applies, or if a partnership interest is distributed by a partnership in a transaction to which section 731(a) applies.

(ii) *Allocations between classes of property.* If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5). If there is an increase in basis to be allocated to partnership assets, such increase must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. Where, under the preceding sentence, an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase shall be allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class. If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704–3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. Where, under the preceding sentence, a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease shall be allocated to each class in proportion to the net loss which would be allocated to the transferee from the sale of all assets in each class.

(iii) *Allocations within the classes*—(A) *Increases.* If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

(B) *Decreases.* If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

(C) *Limitation in decrease of basis.* Where, as the result of a transaction to which this paragraph (b)(5) applies, a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.

(D) *Carryover adjustment.* Where a transferee's negative basis adjustment under section 743(b) cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

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

Example 1. A is a member of partnership LTP, which has made an election under section 754. The three partners in LTP have equal interests in capital and profits. Solely in exchange for a partnership interest in UTP, A contributes its interest in LTP to UTP in a transaction described in section 721. At the time of the transfer, A's basis in its partnership interest ($5,000) equals its share of inside basis (also $5,000). Under section 723, UTP's basis in its interest in LTP is $5,000. LTP's only two assets on the date of contribution are inventory with a basis of $5,000 and a fair market value of $7,500, and a nondepreciable capital asset with a basis of $10,000 and a fair market value of $7,500. The amount of the basis adjustment under section 743(b) to partnership property is $0 ($5,000, UTP's basis in its interest in LTP, minus $5,000, UTP's share of LTP's basis in partnership assets). Because UTP acquired its interest in LTP in a substituted basis transaction, and the total amount of the basis adjustment under section 743(b) is zero, UTP receives no special basis adjustments under section 743(b) with respect to the partnership property of LTP.

Example 2. (i) A purchases a partnership interest in LTP at a time when an election under section 754 is not in effect. The three partners in LTP have equal interests in capital and profits. During a later year for which LTP has an election under section 754 in effect, and in a transaction that is unrelated to A's purchase of the LTP interest, A contributes its interest in LTP to UTP in a transaction described in section 721 (solely in exchange for a partnership interest in UTP). At the time of the transfer, A's adjusted basis in its interest in LTP is $20,433. Under section 721, A recognizes no gain or loss as a result of the contribution of its partnership interest to UTP. Under section 723, UTP's basis in its partnership interest in LTP is $20,433. The balance sheet of LTP on the date of the contribution shows the following:

	Assets	
	Adjusted basis	Fair market value
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Nondepreciable capital asset	20,000	40,000
Total	55,000	76,000

	Liabilities and Capital	
	Adjusted per books	Fair market value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of UTP's interest in LTP and UTP's share of the adjusted basis to LTP of partnership property. UTP's interest in the previously taxed capital of LTP is $15,000 ($22,000, the amount of cash UTP would receive if LTP liquidated immediately after the hypothetical transaction, decreased by $7,000, the amount of tax gain allocated to UTP from the hypothetical transaction). UTP's share of the adjusted basis to LTP of partnership property is $18,333 ($15,000 share of previously taxed capital, plus $3,333 share of LTP's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is $2,100 ($20,433 minus $18,333).

(iii) The total amount of gain that would be allocated to UTP from the hypothetical sale of capital gain property is $6,666.67 (one-third of the excess of the fair market value of LTP's nondepreciable capital asset, $40,000, over its basis, $20,000). The total amount of gain that would be allocated to UTP from the hypothetical sale of ordinary income property is $333.33 (one-third of the excess of the fair market value of LTP's inventory, $21,000, over its basis, $20,000). Under this paragraph (b)(5), LTP must allocate $2,000 ($6,666.67 divided by $7,000 times $2,100) of UTP's basis adjustment to the nondepreciable capital asset. LTP must allocate $100 ($333.33 divided by $7,000 times $2,100) of UTP's basis adjustment to the inventory.

(c) *Adjustments under section 734(b)*—(1) *Allocations between classes of property*—(i) *General rule.* Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

(ii) *Special rule.* Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.

(2) *Allocations within the classes*—(i) *Increases.* If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values.

(ii) *Decreases.* If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).

(3) *Limitation in decrease of basis.* Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property is reduced to zero (but not below zero).

(4) *Carryover adjustment.* Where, in the case of a distribution, an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(5) *Example.* The following example illustrates this paragraph (c):

Example. (i) A, B, and C form equal partnership PRS. A contributes $50,000 and Asset 1, nondepreciable capital gain property with a fair market value of $50,000 and an adjusted tax basis of $25,000. B and C each contributes

$100,000. PRS uses the cash to purchase Assets 2, 3, 4, 5, and 6. Assets 2 and 3 are nondepreciable capital assets, and Assets 4, 5, and 6 are inventory that has not appreciated substantially in value within the meaning of section 751(b)(3). Assets 4, 5, and 6 are the only assets held by the partnership that are subject to section 751. The partnership has an election in effect under section 754. After seven years, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	Fair market value
Capital Gain Property:		
Asset 1	$ 25,000	$ 75,000
Asset 2	100,000	117,500
Asset 3	50,000	60,000
Ordinary Income Property:		
Asset 4	40,000	45,000
Asset 5	50,000	60,000
Asset 6	10,000	2,500
Total	275,000	360,000

(ii) *Allocation between classes.* Assume that PRS distributes Assets 3 and 5 to A in complete liquidation of A's interest in the partnership. A's basis in the partnership interest was $75,000. The partnership's basis in Assets 3 and 5 was $50,000 each. A's $75,000 basis in its partnership interest is allocated between Assets 3 and 5 under sections 732(b) and (c). A will, therefore, have a basis of $25,000 in Asset 3 (capital gain property), and a basis of $50,000 in Asset 5 (section 751 property). The distribution results in a $25,000 increase in the basis of capital gain property. There is no change in the basis of ordinary income property.

(iii) *Allocation within class.* The amount of the basis increase to capital gain property is $25,000 and must be allocated among the remaining capital gain assets in proportion to the difference between the fair market value and basis of each. The fair market value of Asset 1 exceeds its basis by $50,000. The fair market value of Asset 2 exceeds its basis by $17,500. Therefore, the basis of Asset 1 will be increased by $18,519 ($25,000, multiplied by $50,000, divided by $67,500), and the basis of Asset 2 will be increased by $6,481 ($25,000 multiplied by $17,500, divided by $67,500).

(d) *Required statements. See* § 1.743–1(k)(2) for provisions requiring the transferee of a partnership interest to provide information to the partnership relating to the transfer of an interest in the partnership. *See* § 1.743–1(k)(1) for a provision requiring the partnership to attach a statement to the partnership return showing the computation of a basis adjustment under section 743(b) and the partnership properties to which the adjustment is allocated under section 755. *See* § 1.732–1(d)(3) for a provision requiring a transferee partner to attach a statement to its return showing the computation of a basis adjustment under section 732(d) and the partnership properties to which the adjustment is allocated under section 755. *See* § 1.732–1(d)(5) for a provision requiring the partnership to provide information to a transferee partner reporting a basis adjustment under section 732(d).

(e) *Effective Date*—(1) *Generally.* Except as provided in paragraphs (b)(5) and (e)(2) of this section, this section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999.

(2) *Special rules.* Paragraphs (a) and (b)(3)(iii) of this section apply to transfers of partnership interests and distributions of property from a partnership that occur on or after June 9, 2003.

[T.D. 8847, 64 FR 69916, Dec. 15, 1999; 65 FR 9220, Feb. 24, 2000, as amended by T.D. 9059, 68 FR 34295, June 9, 2003]

DEFINITIONS

§ 1.761–1 Terms defined.

(a) *Partnership.* The term *partnership* means a partnership as determined under §§ 301.7701–1, 301.7701–2, and 301.7701–3 of this chapter.

(b) *Partner.* The term *partner* means a member of a partnership.

(c) *Partnership agreement.* For the purposes of subchapter K, a partnership agreement includes the original agreement and any modifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

(d) *Liquidation of partner's interest.* The term *liquidation of a partner's interest* means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. See paragraph (a)(1)(ii) of § 1.731–1.

(e) *Distribution of partnership interest.* For purposes of section 708(b)(1)(B) and § 1.708–1(b)(1)(iv), the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership. However, the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of section 743. This paragraph (e) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (e) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (e) to the termination in a consistent manner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972; T.D. 8697, 61 FR 66588, Dec. 18, 1996; T.D. 8717, 62 FR 25501, May 9, 1997]

§ 1.761–2 Exclusion of certain unincorporated organizations from the application of all or part of subchapter K of chapter 1 of the Internal Revenue Code.

(a) *Exclusion of eligible unincorporated organizations*—(1) *In general.* Under conditions set forth in this section, an unincorporated organization described in subparagraph (2) or (3) of this paragraph may be excluded from the application of all or a part of the provisions of subchapter K of chapter 1 of the Code. Such organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(2) *Investing partnership.* Where the participants in the joint purchase, retention, sale, or exchange of investment property:

(i) Own the property as coowners,

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section.

(3) *Operating agreements.* Where the participants in the joint production, extraction, or use of property:

(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization. In addition, except as provided in paragraph (d)(2)(i) of this section, this paragraph (a)(3) does not apply to any unincorporated organization that produces natural gas under a joint operating agreement, unless all members of the unincorporated organization comply with paragraph (d) of this section.

(b) *Complete exclusion from subchapter K*—(1) *Time for making election for exclusion.* Any unincorporated organization described in subparagraph (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) not later than the time prescribed by paragraph (e) of § 1.6031–1 (including extensions thereof) for filing the partnership return for the first taxable year for which exclusion from subchapter K is desired. Notwithstanding the prior sentence such organization may be deemed to have made the election in the manner prescribed in subparagraph (2)(ii) of this paragraph.

(2) *Method of making election.* (i) Except as provided in subdivision (ii) of this subparagraph, any unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) in a statement attached to, or incorporated in, a properly executed partnership return, Form 1065, which shall contain the information required in this subdivision. Such return shall be filed with the internal revenue officer with whom a partnership return, Form 1065, would be required to be filed if no election were made. Where, for the purpose of determining such officer, it is necessary to determine the internal revenue district (or service center serving such district) in which the electing organization has its principal office or place of business, the principal office or place of business of the person filing the return shall be considered the principal office or place of business of the organization. The partnership return must be filed not later than the time prescribed by paragraph (e) of § 1.6031–1 (including extensions thereof) for filing the partnership return with respect to the first taxable year for which exclusion from subchapter K is desired. Such partnership return shall contain, in lieu of the information required by Form 1065 and by the instructions relating thereto, only the name or other identification and the address of the organization together with information on the return, or in the statement attached to the return, showing the names, addresses, and identification numbers of all the members of the organization; a statement that the organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section; a statement that all of the members of the organization elect that it be excluded from all of subchapter K; and a statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained).

(ii) If an unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section does not make the election provided in section 761(a) in the manner prescribed by subdivision (i) of this subparagraph, it shall nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of subchapter K beginning with the first taxable year of the organization. Although the following facts are not exclusive, either one of such facts may indicate the requisite intent:

(a) At the time of the formation of the organization there is an agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or

(b) The members of the organization owning substantially all of the capital interests report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization.

(3) *Effect of election*—(i) *In general.* An election under this section to be excluded will be effective unless within 90 days after the formation of the organization (or by October 15, 1956, whichever is later) any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such election is irrevocable as long as the organization remains qualified under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, or unless approval of revocation of the election is secured from the Commissioner. Application for permission to revoke the election must be submitted to the Commissioner of Internal Revenue, Attention: T:I, Washington, DC 20224, no later than 30 days after the beginning of the first taxable year to which the revocation is to apply.

(ii) *Special rule.* Notwithstanding subdivision (i) of this subparagraph, an election deemed made pursuant to subparagraph (2)(ii) of this paragraph will not be effective in the case of an organization which had a taxable year ending on or before November 30, 1972, if any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such notification to the Commissioner must be made on or before January 2, 1973 and must include the names and addresses of all of the members of the organization.

(c) *Partial exclusion from subchapter K.* An unincorporated organization which wishes to be excluded from only certain sections of subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of subchapter K. The request shall set forth the sections of subchapter K from which exclusion is sought and shall state that such organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

(d) *Rules for gas producers that produce natural gas under joint operating agreements*—(1) *Joint operating agreements and gas balancing.* Co-owners of a property producing natural gas enter into a joint operating agreement (JOA) to define the rights and obligations of each co- producer of the gas in place. The JOA determines, among other things, each co-producer's proportionate share of the natural gas as it is produced from the reservoir, together with the associated production expenses. A gas imbalance arises when a co-producer does not take its proportionate share of current gas production under the JOA (underproducer) and another co-producer takes more than its proportionate share of current production (overproducer). The co-producers often enter into a gas balancing agreement (GBA) as an addendum to their JOA to establish their rights and obligations when a gas imbalance arises. A GBA typically allows the overproducer to take the amount of the gas imbalance (overproduced gas) and entitles the underproducer to recoup the overproduced gas either from the volume of the gas remaining in the reservoir or by a cash balancing payment.

(2) *Permissible gas balancing methods*—(i) *General requirement.* All co-producers of natural gas operating under the same JOA must use the cumulative gas balancing method, as described in paragraph (d)(3) of this section, unless they use the annual gas balancing method described in paragraph (d)(4) of this section. A co-producer's failure to comply with the provisions of this paragraph (d)(2)(i) generally constitutes the use of an impermissible method of accounting, requiring a change to a permissible method under §1.446–1(e)(3) with any terms and conditions as may be imposed by the Commissioner. The co-producers' election to be excluded from all or part of subchapter K will not be revoked, unless the Commissioner determines that there was willful failure to comply with the requirements of this paragraph (d)(2)(i).

(ii) *Change in method of accounting; adoption of method of accounting*—(A) *In general.* The annual gas balancing method and the cumulative gas balancing method are methods of accounting. Accordingly, a change to or from either of these methods is a change in method of accounting that requires the consent of the Commissioner. See section 446(e) and §1.446–1(e). For purposes of this section, each JOA is treated as a separate trade or business. Paragraph (d)(2)(ii)(B) of this section provides rules for adopting either permissible method of accounting. Paragraph (d)(2)(ii)(C) of this section provides rules on the timing of required changes to either permissible method during the transitional period, and paragraph (d)(5) of this section contains the procedural provisions for making a change in method of accounting required in paragraph (d)(2)(ii)(C) of this section.

(B) *Adoption of method of accounting.* A co-producer must adopt a permissible method for each JOA entered into on or after the start of the co-producer's first taxable year beginning after December 31, 1994 (or, in the case of the use of the annual gas balancing method by co-producers not having the same taxable year, the start of the first taxable year beginning after December 31, 1994, of the co-producer whose taxable year begins latest in the calendar year). If a co-producer is adopting the cumulative method, the co-producer may adopt the method by using the method on its timely filed return for the taxable year of adoption. A co-producer may adopt the annual gas balancing method with the permission of the Commissioner under guidelines set forth in paragraph (d)(4)(ii) of this section.

(C) *Required change in method of accounting for certain joint operating agreements.* This paragraph (d)(2)(ii)(C) applies to certain JOAs entered into prior to 1996. Except in the case of a part-year change in method of accounting or in the case of the cessation of a JOA (both of which are described in this paragraph (d)(2)(ii)(C)), for each JOA entered into prior to a co-producer's first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year, the co-producer must change its method of accounting for sales of gas and its treatment of certain related deductions and credits to a permissible method as of the start of its first taxable year beginning after December 31, 1994. In the case of a JOA of co-producers that do not all have the same taxable year and that choose the annual gas balancing method, if the JOA is entered into prior to the first taxable year beginning after December 31, 1994 of the co-producer whose taxable year begins latest in the calendar year and the JOA is in effect as of January 1, 1996, a change to the annual gas balancing method by each co-producer under that JOA is made as of January 1, 1996 (part-year change in method of accounting). If the co-producers would have made a part-year change to the annual gas balancing method but for the fact that their JOA ceased to be in effect before January 1, 1996 (cessation of a JOA), the co-producers do not change their method of accounting with respect to the JOA. Rather, for their taxable years in which the JOA ceases to be in effect, the co-producers use their current method of accounting with respect to that JOA.

(3) *Cumulative gas balancing method*—(i) *In general.* The cumulative gas balancing method (cumulative method), solely for purposes of reporting income from gas sales and certain related deductions and credits, treats each co-producer under the same JOA as the sole owner of its percentage share of the total gas in the reservoir and disregards the ownership arrangement described in the JOA for gas as it is produced from the reservoir. Each co-producer is considered to be taking only its share of the total gas in the reservoir as long as the gas remaining in the reservoir is sufficient to satisfy the ownership rights of the co-producers in their percentage shares of the total gas in the reservoir. After a co-producer has taken its entire share of the total gas in the reservoir, any additional gas taken by that co-producer (taking co-producer) is treated as having been taken from its other co-producers' shares of the total gas in the reservoir. The effect of being treated as a taking co-producer under the cumulative method is that the taking co-producer generally may not claim an allowance for depletion and a production credit on its sales of its other co-producers' percentage shares of the total gas in the reservoir.

(ii) *Requirements*—(A) *Reporting of income from sales of gas.* Under the cumulative method, each co-producer must include in gross income under its overall method of accounting the amount of its sales from all gas produced from the reservoir, including sales of gas taken from another co-producer's share of the gas in the reservoir.

(B) *Reporting of deduction of taking co-producer.* A taking co-producer deducts the amount of a payment (in cash or property, other than gas produced under the JOA) made to another co-producer for sales of that co-producer's gas, but only for the taxable year in which the payment is made. Thus, an accrual method taking co-producer is not permitted a deduction for any obligation it has to pay another co-producer for sales of that co-producer's gas until a payment is made. See paragraph (d)(3)(iii)(B) of this section for a rule requiring a reduction of the amount of the deduction described in this paragraph (d)(3)(ii)(B) if the taking co-producer had mistakenly claimed a depletion deduction relating to those sales.

(C) *Reporting of income by other co-producers.* Any co-producer that is entitled to receive a payment from a taking co-producer must include the amount of the payment in gross income as proceeds from the sale of its gas only for the taxable year that the payment is actually received, regardless of its overall method of accounting.

(D) *Reporting of production expenses.* Each co-producer deducts its proportionate share of production expenses, as provided in the JOA, under its regular method of accounting for the expenses.

(iii) *Special rules for production credits and depletion deductions under the cumulative method*—(A) *In general.* Under the cumulative method, a co-producer's depletion allowance and production credit for a taxable year are based on its income from gas sales and production of gas from its percentage share of the total gas in the reservoir, and are not based on its current proportionate share of income and production as determined under the JOA. Thus, in general, a taking co-producer is not allowed a production credit or an allowance for depletion on its sales of gas in excess of its percentage share of the total gas in the reservoir. However, the Service will not disallow depletion deductions or production credits claimed by a taking co-producer on the gas of other co-producers if the taking co-producer had a reasonable but mistaken belief that the deductions or credits were claimed with respect to the taking co-producer's percentage share of total gas in the reservoir and the taking co-producer makes the appropriate reductions and additions to tax required in paragraphs (d)(3)(iii)(B) and (d)(3)(iii)(C) of this section. The reasonableness of the mistaken belief is determined at the time of filing the return claiming the deductions or credits. A co-producer receiving a payment for sales of its gas from a taking co-producer claims a production credit and an allowance for depletion relating to those sales only for the taxable year in which the amount of the payment is included in its gross income.

(B) *Reduction of taking co-producer's payment deduction for depletion claimed on another co-producer's gas.* If a taking co-producer claims an allowance for depletion on another co-producer's gas, the taking co-producer must reduce its deduction claimed in a later year for making a payment to the other co-producer for sales of that co-producer's gas by the amount of any percentage depletion deduction allowed on the gas sales to which the payment relates. If the percentage limitation of section 613A(d)(1) applied to disallow a depletion deduction for a previous year, the taking co-producer must reduce the amount of any carried over depletion deduction allowable in the year of the payment or in a future year by the portion of the carried over depletion deduction, if any, that relates to another co-producer's gas.

(C) *Addition to tax of taking co-producer for production credit claimed on another co-producer's gas.* If a taking co-producer claims a production credit on another co-producer's gas, the taking co-producer must add to its tax for the taxable year that it makes a payment to the other co-producer for sales of that co-producer's gas any production credit allowed in an earlier taxable year on the gas sales to which the payment relates, but only to the extent the credit allowed actually reduced the taking co- producer's tax in any earlier year. The taking co-producer also must reduce the amount of its minimum tax credit allowable by reason of section 53(d)(1)(B)(iii) in the year of the payment or in a future year by the portion of the credit, if any, that relates to another co-producer's gas.

(iv) *Anti-abuse rule.* If the Commissioner determines that co-producers using the cumulative method have arranged or altered their taking of production for a taxable year with a principal purpose of shifting the income, deductions, or credits relating to that production to avoid tax, the co- producers' election to be excluded from all or part of subchapter K will be revoked for that year and for subsequent years. In determining that a principal purpose was to avoid tax, the Commissioner will examine all the facts and circumstances surrounding the use of the cumulative method by the co-producers. See *Examples 3* and *4* of paragraph (d)(6) of this section.

(4) *Annual gas balancing method*—(i) *In general.* The annual gas balancing method (annual method) takes into account each co-producer's ownership rights and obligations, as described in the JOA, with respect to the co-producer's current proportionate share of gas as it is produced from the reservoir. Under the annual method, gas imbalances relating to a JOA must be eliminated annually through a balancing payment, which may be in the form of cash, gas produced under the same JOA, or other property. If all the co-producers under a JOA have the same taxable year, any gas imbalance remaining at the end of a taxable year must be eliminated by a balancing payment from the overproducer to the underproducer by the due date of the overproducer's tax return for that taxable year (including extensions). If all the co-producers under a JOA do not have the same taxable year, any gas imbalance remaining at the end of a calendar year must be eliminated by a balancing payment from the overproducer to the underproducer by September 15 of the following calendar year. The annual method may be used only if the Commissioner's permission is obtained. Paragraph (d)(4)(ii) of this section provides guidelines for applying for this permission. The annual method is not available for a JOA with respect to which any co-producer made an election under paragraph (d)(5)(i)(B)(*3*) of this section (to take an aggregate section 481(a) adjustment for all JOAs of a co-producer into account in the year of change).

(ii) *Obtaining the Commissioner's permission to use the annual method.* A request for the Commissioner's permission to adopt the annual method for a new JOA must be in writing and must set forth the names of all the co-producers under the JOA and the respective taxable year of adoption. See paragraphs (d)(2)(ii) and (d)(5)(ii) of this section for the rules for a change in method of accounting to the annual method. In addition, the request must contain an explanation of how the co-producers will report income from gas sales, the making or receiving of a balancing payment, production expenses, depletion deductions, and production credits. Permission will be granted under appropriate conditions, including, but not limited to, an agreement in writing by all co-producers to use the annual method and to eliminate any gas imbalances annually in accordance with paragraph (d)(4)(i) of this section.

(5) *Transitional rules for making a change in method of accounting required in paragraph (d)(2)(ii)(C) of this section*—(i) *Change in method of accounting to the cumulative method*—(A) *Automatic consent to change in method of accounting to the cumulative method.* A co-producer changing to the cumulative method for any JOA entered into prior to its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year is granted the consent of the Commissioner to change its method of accounting with respect to each JOA to the cumulative method, provided the co-producer—

(*1*) Makes the change on its timely filed return for its first taxable year beginning after December 31, 1994;

(*2*) Attaches a completed and signed Form 3115 to the co-producer's tax return for the year of change, stating that, pursuant to § 1.761–2(d)(2)(ii) of the regulations, the co-producer is changing its method of accounting for sales of gas and its treatment of certain related deductions and credits under each JOA to the cumulative method;

(*3*) In the case of a co-producer making an election under paragraph (d)(5)(i)(B)(*3*) of this section to take the aggregate section 481(a) adjustment into account in the year of change, attaches the statement described in paragraph (d)(5)(i)(B)(*3*)(*ii*) of this section; and

(*4*) In the case of a co-producer not making an election under paragraph (d)(5)(i)(B)(*3*) of this section, attaches a list of each JOA with respect to which there is a section 481(a) adjustment computed in accordance with paragraph (d)(5)(i)(B)(*2*)(*i*) of this section.

(B) *Section 481(a) adjustment*—(*1*) *Application of section 481(a).* A change in method of accounting to the cumulative method under the automatic consent procedure in paragraph (d)(5)(i)(A) of this section is a change in method of accounting to which the provisions of section 481(a) apply. Thus, a section 481(a) adjustment must be taken into account in the manner provided by this paragraph (d)(5)(i)(B) to prevent the omission or duplication of income. Paragraph (d)(5)(i)(B)(*2*) of this section provides the general rules for computing the amount of the section 481(a) adjustment of a co-producer relating to a particular JOA and for taking the section 481(a) adjustment into account. Paragraph (d)(5)(i)(B)(*3*) of this section provides rules for electing to take a co-producer's section 481(a) adjustment computed on an aggregate basis for all JOAs into account in the year of change. Paragraph (d)(5)(i)(C) of this section provides rules to coordinate the taking of a depletion deduction or a production credit with the inclusion of a section 481(a) adjustment arising from a change in method of accounting to the cumulative method under this paragraph (d)(5)(i).

(*2*) *Computation of the section 481(a) adjustment relating to a joint operating agreement*—(*i*) *In general.* The section 481(a) adjustment of a co-producer relating to a JOA is computed as of the first day of the co-producer's year of change and is equal to the difference between the amount of income reported under the co-producer's former method of accounting for all taxable years prior to the year of change and the amount of income that would have been reported if the co-producer's new method had been used in all those taxable years.

(*ii*) *Section 481(a) adjustment period.* Except to the extent that paragraph (d)(5)(i)(B)(*3*) of this section applies, a co-producer's section 481(a) adjustment relating to a JOA, whether positive or negative, is taken into account in computing taxable income ratably over the 6-taxable-year period beginning with the year of change (the section 481(a) adjustment period). If the co-producer has been in existence less than 6 taxable years, the adjustment is taken into account over the number of years the co-producer has been in existence. If the co-producer ceases to engage in the trade or business that gave rise to the section 481(a) adjustment at any time during the section 481(a) adjustment period, the entire remaining balance of the section 481(a) adjustment relating to that trade or business must be taken into account in the year of the cessation. For purposes of this paragraph (d)(5)(i)(B)(*2*)(*ii*), production under each JOA is treated as a separate trade or business. The determination as to whether the co-producer ceases to engage in its trade or business is to be made under the principles of §1.446-–1(e)(3)(ii) and its underlying administrative procedures. For example, the permanent cessation of production under a co-producer's JOA constitutes the cessation of a trade or business of the co-producer. Accordingly, for the year that production under a JOA permanently ceases, the remaining balance of the section 481(a) adjustment relating to the JOA must be taken into account.

(*3*) *Election to take aggregate section 481(a) adjustment for all joint operating agreements into account in the year of change*—(*i*) *In general.* A co-producer may elect to take into account its section 481(a) adjustment, computed on an aggregate basis for all of its JOAs, whether negative or positive, in the year of change, provided the co-producer uses the cumulative method for all of its JOAs entered into prior to its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year. The aggregate section 481(a) adjustment of a co-producer is equal to the difference between the amount of income reported under the co-producer's former method of accounting for all taxable years prior to the year of change and the amount of income that would have been reported if the co-producer's new method had been used in all of those taxable years for all JOAs for which the co-producer changes its method of accounting. An election made under this paragraph (d)(5)(i)(B)(*3*) is irrevocable. If any person who, together with another person, would be treated as a single taxpayer under section 41(f)(1) (A) or (B) makes an election under this paragraph (d)(5)(i)(B)(*3*), all persons within that single taxpayer group will be treated as if they had made an election under this paragraph (d)(5)(i)(B)(*3*) and, as such, will be irrevocably bound by that election. If a co-producer does not make an election under this paragraph, each JOA entered into prior to the start of its first taxable year beginning after December 31, 1994, and in effect as of the beginning of that year must be accounted for separately in computing the section 481(a) adjustment and taxable income of the co-producer for any year to which this paragraph (d) applies.

(*ii*) *Time and manner for making the election.* An election under this paragraph (d)(5)(i)(B)(*3*) is made by attaching a statement to the co-producer's timely filed return for its year of change indicating that the co- producer is electing under §1.761–2(d)(5)(i)(B)(*3*) to take its aggregate section 481(a) adjustment into account in the year of change.

(C) *Treatment of section 481(a) adjustment as a sale for purposes of computing a production credit and as gross income from the property for purposes of depletion deductions.* Any positive section 481(a) adjustment arising as a result of a change in method of accounting for gas imbalances under this paragraph (d)(5)(i) and taken into account in computing taxable income under paragraph (d)(5)(i)(B) of this section is considered a sale by the taxpayer for purposes of computing any production credit in the year that the adjustment is taken into account. Similarly, the positive section 481(a) adjustment is considered *gross income from the property* and *taxable income from the property* for purposes of computing depletion deductions in the year the adjustment is taken into account. Sales amounts used in computing any production credit in any year in which a negative section 481(a) adjustment is taken into account in computing taxable income under paragraph (d)(5)(i)(B) of this section must be reduced by the amount of the negative section 481(a) adjustment taken into account in that year. Similarly, gross income from the property and taxable income from the property used in computing any depletion deduction in any year in which the negative section 481(a) adjustment is taken into account must be reduced by the amount of the negative adjustment. For these purposes, any taxpayer that makes an aggregate section 481(a) adjustment election under paragraph (d)(5)(i)(B)(*3*) of this section must allocate the adjustment among its properties in any reasonable manner that prevents a duplication or omission of depletion deductions.

(ii) *Change in method of accounting to the annual method*—(A) *In general.* A co-producer changing to the annual method in accordance with paragraph (d)(2)(ii) of this section must request a change under § 1.446–1(e)(3) and will be subject to any terms and conditions as may be imposed by the Commissioner.

(B) *Section 481(a) adjustment.* A change in method of accounting to the annual method is a change in method of accounting to which the provisions of section 481(a) apply. Thus, a section 481(a) adjustment must be taken into account to prevent the omission or duplication of income. If all the co-producers under a JOA have the same taxable year, the section 481(a) adjustment involved in a change to the annual method by a co-producer relating to the JOA is computed as of the first day of the co-producer's year of change. If the co-producers under a JOA do not all have the same taxable year (that is, in the case of a part-year change described in paragraph (d)(2)(ii)(C) of this section), the change in method of accounting occurs on January 1, 1996, and the section 481(a) adjustment is computed on that date.

(iii) *Untimely change in method of accounting to comply with this section.* Unless a co-producer required by this section to change its method of accounting complies with the provisions of this paragraph (d)(5) for its first applicable taxable year within the time prescribed by this paragraph (d)(5), the co-producer must take the section 481(a) adjustment into account under the provisions of any applicable administrative procedure that is prescribed by the Commissioner specifically for purposes of complying with this section. Absent such an administrative procedure, a co-producer must request a change under § 1.446–1(e)(3) and will be subject to any terms and conditions as may be imposed by the Commissioner.

(6) *Examples.* The following examples illustrate the application of the cumulative method described in paragraph (d)(3) of this section.

Example 1. Operation of the cumulative method. (i) L, a corporation using the cash receipts and disbursements method of accounting, and M, a corporation using an accrual method, file returns on a calendar year basis. On January 1, 1995, L and M enter into a JOA to produce natural gas as an unincorporated organization from a reservoir located in State Y. The JOA allocates reservoir production 60 percent to L and 40 percent to M. L and M enter into a GBA as an addendum to the JOA. L and M agree to use the cumulative method to account for gas sales from the reservoir and elect under section 761(a) and this section to exclude the organization from the application of subchapter K. Production from the reservoir is eligible for the section 29 credit for producing fuel from a nonconventional source. L and M produce and sell the following amounts of natural gas (in mmcf) until 2000 during which year production from the reservoir ceases:

	1995	1996	1997	1998	1999	2000
L	720	480	600	–0–	–0–	–0–
M	240	60	120	160	80	40

(ii) By the end of 1996, neither L nor M has fully produced its percentage share of the total gas in the reservoir. In 1997, L produces a total of 600 mmcf of gas at the rate of 50 mmcf per month. Prior to filing its return for 1997, L determines that it fully produced its percentage share of gas in the reservoir as of June 30, 1997. Pursuant to the GBA executed by L and M, L pays M at the end of 2000 for the 300 mmcf of M's gas (as determined under the cumulative method) that L sold in the last half of 1997.

(iii) For 1995, L and M must include in their gross income the amounts relating to gas sales of 720 mmcf and 240 mmcf, respectively. For 1996, L and M must include the amounts relating to gas sales of 480 mmcf and 60 mmcf, respectively. For both 1995 and 1996, L and M compute an allowance for depletion and a section 29 credit based upon gas taken and sold by each from the reservoir for each taxable year.

(iv) For 1997, L and M must include in gross income the amounts relating to their gas sales of 600 mmcf and 120 mmcf, respectively. Under paragraph (d)(3)(iii)(A) of this section, L computes an allowance for depletion and the section 29 credit based only on production from L's proportionate share of gas in the reservoir (that is, based on L's production through June 30, 1997). Accordingly, for 1997, L claims depletion and the section 29 credit only with respect to 300 mmcf of gas

(50 mmcf per month × 6 months). For 1997, because M has not fully produced from its percentage share of the total gas in the reservoir as of the end of 1997, M claims depletion and the section 29 credit on the 120 mmcf that M produced in 1997.

(v) In 1998 and 1999, M must include in gross income the amounts relating to M's sales of gas, that is, 160 mmcf for 1998 and 80 mmcf for 1999. For 2000, M must include in gross income the amount relating to sales of 340 mmcf of gas, which consists of its own sales of 40 mmcf plus the payment for 300 mmcf of gas that L made to M for having sold from M's share of the total gas in the reservoir during the last half of 1997. Because M produced from its percentage share of the total gas in the reservoir during 1998, 1999, and 2000, M claims a depletion deduction and a section 29 credit on its income and production for those years, that is, 160 mmcf for 1998, 80 mmcf for 1999, and 40 mmcf for 2000. Additionally, for 2000, M claims depletion and the section 29 credit relating to the payment that M received from L for the 300 mmcf of M's gas that L sold in the last half of 1997. Under paragraph (d)(3)(ii)(B) of this section, L's deduction for its payment to M for the 300 mmcf of M's gas that L sold in 1997 is allowable only for 2000.

Example 2. Adjustments under the cumulative method for depletion deductions and production credits that were claimed for sales in excess of a co-producer's percentage share of total gas in the reservoir. (i) L, a corporation using the cash receipts and disbursements method of accounting, and M, a corporation using an accrual method, file returns on a calendar year basis. On January 1, 1995, L and M enter into a JOA to produce natural gas as an unincorporated organization from a reservoir located in State Y. The JOA allocates reservoir production 60 percent to L and 40 percent to M. L and M enter into a GBA as an addendum to the JOA. L and M agree to use the cumulative method to account for gas sales from the reservoir and elect under section 761(a) and this section to exclude the organization from the application of subchapter K. Production from the reservoir is eligible for the section 29 credit for producing fuel from a nonconventional source. L and M produce and sell the following amounts of natural gas (in mmcf) until 2000 during which year production from the reservoir ceases:

	1995	1996	1997	1998	1999	2000
L	720	480	600	60	60	–0–
M	240	60	120	60	60	40

(ii) In addition, L does not realize until December 31, 1999, that L fully produced its percentage share of the total gas in the reservoir as of June 30, 1997. At the time of filing its returns for 1997 and 1998, L reasonably believes that during 1997 and 1998, respectively, it did not fully produce its percentage share of the total gas in the reservoir. Thus, L claims depletion and the section 29 credit for its total sales of 600 mmcf in 1997 and 60 mmcf in 1998. Pursuant to the GBA executed by L and M, L pays M at the end of 2000 for the 420 mmcf of M's gas (as determined under the cumulative method) that L sold (300 mmcf in the last half of 1997 (assuming that production was at a rate of 50 mmcf per month), 60 mmcf in 1998, and 60 mmcf in 1999).

(iii) In 1997 and 1998, L and M include in gross income the amounts relating to their respective sales of gas, that is, for L 600 mmcf for 1997 and 60 mmcf for 1998, and for M 120 mmcf for 1997 and 60 mmcf for 1998.

(iv) For 1999, L must include in gross income the amount of its sales of 60 mmcf, but may not claim depletion or the section 29 credit on those sales. For 1999, M must include in gross income the amount of its sales of 60 mmcf and claims depletion and the section 29 credit with respect to those 60 mmcf.

(v) For 2000, M must include in gross income the amount relating to gas sales of 460 mmcf, that is, the amount of M's own gas sales of 40 mmcf and the amount of the payment received from L for the 420 mmcf of M's gas that L sold (consisting of 300 mmcf in 1997, 60 mmcf in 1998, and 60 mmcf in 1999). Under paragraph (d)(3)(iii)(A) of this section, M computes a depletion deduction and a production credit relating to the amount of M's actual gas sales for 2000 and the payment received from L, that is, relating to a total of 460 mmcf of gas (M's sales of 40 mmcf for 2000, plus L's payment for 420 mmcf of gas). Under paragraph (d)(3)(ii)(B) of this section, L's deduction for making its payment to M for 420 mmcf of gas is allowable only for 2000. Under paragraph (d)(3)(iii)(B) of this section, L must reduce its deduction by the amount of any percentage depletion deductions allowed on its sales of M's gas, that is, relating to 360 mmcf of gas (300 mmcf for 1997 and 60 mmcf for 1998). In addition, under paragraph (d)(3)(iii)(C) of this section, L must increase its tax for 2000 by the amount of any section 29 credit L claimed on its sales of M's gas, but only to the extent that the credit claimed actually reduced L's tax in any earlier year.

Example 3. Non-abusive altering of the taking of production for a taxable year. (i) C and D enter into a JOA and a GBA on December 1, 1994, for gas production from a reservoir. The JOA allocates production at 50 percent to C and 50 percent to D. C and D agree in writing to use the cumulative method to account for gas sales. Additionally, C and D elect under section 761(a) and this section to exclude their organization from the application of subchapter K. C and D arrange to sell all their production under annually renewable contracts. In 1995, C and D each sell 480 mmcf of gas from the reservoir.

(ii) In November 1995, D is notified that its contract with its purchaser will not be renewed for 1996. D is unable to find a new purchaser for its gas for 1996. In December 1995, D notifies C that it will not be taking production from the reservoir in 1996. Pursuant to the GBA, C then contracts with its current gas purchaser to sell an additional 20 mmcf per month in 1996. Accordingly, C sells 720 mmcf in 1996 (60 mmcf per month × 12 months). Under the facts described in this example, a principal purpose of altering the taking of production is not to avoid tax. Accordingly, the co-producers' election under section 761(a) will not be revoked by reason of altering the taking of production.

Example 4. Abusive altering of the taking of production for a taxable year. The facts are the same as in *Example 3*(i). For 1996, C anticipates that C's regular tax (reduced by the credits allowable under sections 27 and 28) will not exceed C's tentative minimum tax. Accordingly, under section 29(b)(6), C's credit allowed under section 29(a) for sales of its gas will be zero. For 1997, C anticipates that its credit allowed under section 29(a) will not be limited by section 29(b)(6). On the other hand, D anticipates that any credit it may claim under section 29(a) for 1996, even including a credit based on sales of C's share of current production under the JOA, will not be limited by section 29(b)(6). However, for 1997, D anticipates that its credit under section 29(a) will be limited by section 29(b)(6). On January 1, 1996, C and D agree that D will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1996 and that C will contract with its purchaser to sell the entire 960 mmcf produced from the reservoir in 1997. Under these facts, a principal purpose of altering the taking of production is to avoid tax. Accordingly, the co-producers' election under section 761(a) will be revoked for 1996 and for subsequent years.

(7) *Effective date.* Except in the case of a part-year change to the annual method or the cessation of a JOA, both of which are described in paragraph (d)(2)(ii)(C) of this section, the provisions of this paragraph (d) apply to all taxable years beginning after December 31, 1994, of any producer that is a member of an unincorporated organization that produces natural gas under a JOA in effect on or after the start of the producer's first taxable year beginning after December 31, 1994. In the case of a part-year change, the provisions of this paragraph (d) apply on and after January 1, 1996. In the case of the cessation of a JOA, the co-producers use their current method of accounting with respect to that JOA until the JOA ceases to be in effect.

(e) *Cross reference.* For requirements with respect to the filing of a return on Form 1065 by a partnership, see § 1.6031–1.

[T.D. 7208, 37 FR 20687, Oct. 3, 1972; 37 FR 23161, Oct. 31, 1972, as amended by T.D. 8578, 59 FR 66183, Dec. 23, 1994; 60 FR 11028, Mar. 1, 1995]

EFFECTIVE DATE FOR SUBCHAPTER K, CHAPTER 1 OF THE CODE

§ 1.771–1 Effective date.

(a) *General rule.* Except as provided in paragraph (b) or (c) of this section, the provisions of subchapter K, chapter 1 of the Code, shall apply to any taxable year of a partnership beginning after December 31, 1954, and to any part of a partner's taxable year falling within such partnership taxable year. The provisions of the Internal Revenue Code of 1939 relating to partnerships shall apply to any taxable year of a partnership beginning before January 1, 1955, and to any part of a partner's taxable year falling within such partnership taxable year. If a partnership and the partners are on different taxable years, subchapter K shall become effective at the same time both for the partnership and for the partners.

(b) *Special rules.* Certain provisions of section 771 apply after specific dates in 1954, as follows:

(1) *Adoption of taxable year.* Section 706(b) (relating to the adoption of taxable years by partners and partnerships), shall apply to any partnership which adopts or changes to, and any partner who changes to, a taxable year beginning on or after April 2, 1954. For the purpose of applying this subparagraph, the rules of section 708 (relating to the continuation of partnerships) shall apply. For example, if two or more partnerships merge after April 1, 1954, and the new partnership uses the taxable year of the partnership of which it is deemed to be the successor under section 708(b)(2)(A), it will not need prior approval to continue to use such taxable year even though such year may be different from the taxable years of the partners. Such a partnership is not ''adopting'' or ''changing'' its taxable year.

(2) *Property distributed by a partnership.* Section 735(a), relating to the character of gain or loss on disposition of property distributed by a partnership to a partner, shall apply only to property distributed after March 9, 1954. Although a partnership whose taxable year begins before January 1, 1955, generally will be subject to the provisions of the Internal Revenue Code of 1939, any unrealized receivables or inventory items distributed by any such partnership after March 9, 1954, will be subject to the provisions of section 735(a), and the gain or loss on the subsequent disposition of such property will be ordinary gain or loss rather than capital gain or loss. In the case of property distributed before March 10, 1954, section 735(a) will not apply, even though the property is disposed of by the distributee partner after that date, unless the partnership elects under paragraph (c) of this section to apply section 735.

(3) *Unrealized receivables and inventory items.* Section 751 (providing for the realization of ordinary income on certain transfers or distributions of unrealized receivables or substantially appreciated inventory items) shall be applicable to any such transfer or distribution occurring after March 9, 1954. For the purpose of applying section 751 in the case of a taxable year beginning before January 1, 1955, a partnership or partner may elect to treat as applicable any other section of subchapter K. See paragraph (f) of § 1.751–1.

(4) *Partner receiving income in respect of a decedent.* Section 753, which provides that the amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691, shall apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954.

(c) *Optional treatment of certain distributions.* (1) For a partnership taxable year beginning after December 31, 1953, and before January 1, 1955, a partnership may elect to apply the rules of certain sections of subchapter K with respect to current distributions made by the partnership in such year. These sections are 731, 732 (a), (c), and (e), 733, 735, and 751 (b), (c), and (d). If an election is made, it shall apply to the partnership and all its members for all current distributions made by the partnership during the taxable year. Such distributions shall also be subject to the rules of section 705 (relating to determination of basis of a partner's interest), 752 (relating to treatment of certain liabilities), and 761(d) (relating to the definition of liquidation of a partner's interest), to the extent that such sections apply to current distributions.

(2) An election under this paragraph shall be made by a statement filed with the partnership return for the taxable year to which such election applies, or before August 23, 1956, whichever date is later. The statement shall be signed by all members of the partnership and the election once made shall be binding on the partnership and on all of its members.

INSURANCE COMPANIES

LIFE INSURANCE COMPANIES

DEFINITION; TAX IMPOSED

§ 1.801–1 Definitions.

(a) *Life insurance company.* The term *life insurance company* as used in subtitle A of the Code is defined in section 801. For the purpose of determining whether a company is a ''life insurance company'' within the meaning of that term as used in section 801, it must first be determined whether the company is taxable as an insurance company under the Code. For the definition of an ''insurance company'', see paragraph (b) of this section. In determining whether an insurance company is a life insurance company, the life insurance reserves (as defined in section 803(b)) plus any unearned premiums and unpaid losses on noncancellable life, health, or accident policies, not included in ''life insurance reserves'' must comprise more than 50 percent of its total reserves (as defined in section 801). An insurance company writing only noncancellable life, health, or accident policies and having no ''life insurance reserves'' may qualify as a life insurance company if its unearned premiums and unpaid losses on such policies comprise more than 50 percent of its total reserves. A noncancellable insurance policy means a contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium must be carried to cover that obligation. For the purpose of the preceding sentence, the term ''unearned premium'' means the amount which will cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance. A burial or funeral benefit insurance company qualifying as a life insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services will be taxable under section 821 or section 831 as an insurance company other than life.

(b) *Insurance companies.* (1) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

(2) Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code. For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1954 within the meaning of the Code and the regulations thereunder.

§ 1.801–2 Taxable years affected.

Section 1.801–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.801–3 through 1.801–7 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112). Section 1.801–8 is applicable only to taxable years beginning after December 31, 1961, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 3 of the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8681, June 23, 1966]

§ 1.801–3 Definitions.

For purposes of part I, subchapter L, chapter 1 of the Code, this section defines the following terms, which are to be used in determining if a taxpayer is a life insurance company (as defined in section 801(a) and paragraph (b) of this section):

(a) *Insurance company.* (1) The term *insurance company* means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

(2) Insurance companies include both stock and mutual companies, as well as

mutual benefit insurance companies. For taxable years beginning before January 1, 1970, a voluntary unincorporated association of employees, including an association fulfilling the requirements of section 801(b)(2)(B) (as in effect for such years), formed for the purpose of relieving sick and aged members and the dependents of deceased members, is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not an insurance company, and the income from such fund shall be included in the return of the corporation.

(b) *Life insurance company.* (1) The term *life insurance company*, as used in subtitle A of the Code, is defined in section 801(a). For the purpose of determining whether a company is a ''life insurance company'' within the meaning of that term as used in section 801(a), it must first be determined whether the company is taxable as an insurance company (as defined in paragraph (a) of this section). An insurance company shall be taxed as a life insurance company if it is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, and its life insurance reserves (as defined in section 801(b) and §1.801–4), plus unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in section 801(c) and §1.801–5). For purposes of determining whether it satisfies the percentage requirements of the preceding sentence, a company shall first make any adjustments to life insurance reserves and total reserves required by section 806(a) (relating to adjustments for certain changes in reserves and assets) and then as required by section 801(d) (relating to adjustments in reserves for policy loans). For examples of the adjustments required under section 806(a), see paragraph (b)(4) of §1.806–3. For an example of the adjustments required under section 801(d), see paragraph (c) of §1.801–6. Furthermore, if an insurance company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), such revalued basis shall be disregarded for purposes of section 801.

(2) An insurance company writing only noncancellable life, health, or accident policies and having no ''life insurance reserves'' may qualify as a life insurance company if its unearned premiums, and unpaid losses (whether or not ascertained), on such policies comprise more than 50 percent of its total reserves.

(3) Section 801(f) provides that a burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under section 802 but shall be taxable under section 821 or section 831 as an insurance company other than life.

(c) *Noncancellable life, health, or accident insurance policy.* The term *noncancellable life, health, or accident insurance policy* means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. Such a health and accident contract shall be considered noncancellable even though it states a termination date at a stipulated age, if, with respect to the health and accident contract, such age termination date is 60 or over. Such a contract, however, shall not be considered to be noncancellable after the age termination date stipulated in the contract has passed. However, if the age termination date stipulated in the contract occurs during the period covered by a premium received by the life insurance company prior to such date, and the company cannot cancel or modify the contract during such period, the age termination date shall be deemed to occur at the expiration of the period for which the premium has been received.

(d) *Guaranteed renewable life, health, and accident insurance policy.* The term *guaranteed renewable life, health, and accident insurance policy* means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved, and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. Section 801(e) provides that such policies shall be treated in the same manner as noncancellable life, health, and accident insurance policies. For example, the age termination date requirements applicable to noncancellable health and accident insurance policies shall also apply to guaranteed renewable life, health, and accident insurance policies. See paragraph (c) of this section.

(e) *Unearned premiums.* The term *unearned premiums* means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

(f) *Life insurance reserves.* For the definition of the term ''life insurance reserves'', see section 801(b) and § 1.801–4.

(g) *Unpaid losses (whether or not ascertained).* The term *unpaid losses (whether or not ascertained)* means a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases):

(1) Reported and ascertained by the end of the taxable year but where the amount of the loss has not been paid by the end of the taxable year,

(2) Reported by the end of the taxable year but where the amount thereof has not been either ascertained or paid by the end of the taxable year, or

(3) Which have occurred by the end of the taxable year but which have not been reported or paid by the end of the taxable year.

(h) *Total reserves.* For the definition of the term *total reserves,* see section 801(c) and § 1.801–5.

(i) *Amount of reserves.* For purposes of subsections (a), (b), and (c) of section 801 and this section, section 801(b)(5) provides that the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

[T.D. 6513, 25 FR 12655, Dec. 10, 1960, as amended by T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§ 1.801–4 Life insurance reserves.

(a) *Life insurance reserves defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term *life insurance reserves* (as defined in section 801(b)) means those amounts:

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term ''reserves required by law'', see paragraph (b) of § 1.801–5.

For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10, the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves. Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life insurance reserves, see paragraph (e) of this section.

(b) *Certain reserves which need not be required by law.* Section 801(b)(2) sets forth certain reserves which, though not required by law, may still qualify as life insurance reserves, provided, however, that they first satisfy the requirements of section 801(b)(1) (A) and (B) and paragraph (a) (1) and (2) of this section. Thus, reserves need not be required by law:

(1) In the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

(2) For taxable years beginning before January 1, 1970, in the case of policies issued by an organization which met the requirements of section 501(c)(9) (as it existed prior to amendment by the Tax Reform Act of 1969) other than the requirement of subparagraph (B) thereof.

(c) *Assessment companies.* Section 801(b)(3) provides that in the case of an assessment life insurance company or association, the term *life insurance reserves* includes:

(1) Sums actually deposited by such company or association with officers of a State or Territory pursuant to law as guaranty or reserve funds, and

(2) Any funds maintained, under the charter or articles of incorporation or association of such company or association (or bylaws approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

For purposes of part I, subchapter L, chapter 1 of the Code, the reserves described in this paragraph shall be included as life insurance reserves even though such reserves do not meet the requirements of section 801(b) and paragraph (a) of this section. However, for such reserves to be included as life insurance reserves, they must be deposited or maintained to liquidate future unaccrued claims arising from life insurance, annuity, or noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is deposited or maintained, life, health, or accident contingencies. The rate of interest assumed in calculating the reserves described in this paragraph shall be 3 percent, regardless of the rate of interest (if any) specified in the contract in respect of such reserves.

(d) *Reserves which qualify as life insurance reserves.* The following reserves, provided they meet the requirements of section 801(b) and paragraph (a) of this section, are illustrative of reserves which shall be included as life insurance reserves:

(1) Reserves held under life insurance contracts.

(2) Reserves held under annuity contracts (including reserves held under variable annuity contracts as described in section 801(g)(1)).

(3) Reserves held under noncancellable health and accident insurance contracts (as defined in paragraph (c) of § 1.801–3) and reserves held under guaranteed renewable health and accident insurance contracts (as defined in paragraph (d) of § 1.801–3).

(4) Reserves held either separately or combined under contracts described in subparagraphs (1), (2), or (3) of this paragraph.

(5) Reserves held under deposit administration contracts. Generally, the reserves held by a life insurance company on both the active and retired

lives under deposit administration contracts will meet the requirements of section 801(b) and paragraph (a) of this section.

However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. See paragraph (a) of this section.

(e) *Reserves and liabilities which do not qualify as life insurance reserves.* The following are illustrative of reserves and liabilities which do not meet the requirements of section 801(b) and paragraph (a) of this section and, accordingly, shall not be included as life insurance reserves:

(1) Liability for supplementary contracts not involving at the time with respect to which the liability is computed, life, health, or accident contingencies.

(2) In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums and unpaid losses (whether or not ascertained).

(3) The unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies (and guaranteed renewable life, health, and accident policies) not included in life insurance reserves. (However, such amounts shall be taken into account under section 801(a)(2) for purposes of determining whether an insurance company is a life insurance company.)

(4) The deficiency reserve (as defined in section 801(b)(4)) for each individual contract, that is, that portion of the reserve for such contract equal to the amount (if any) by which:

(i) The present value of the future net premiums required for such contract, exceeds

(ii) The present value of the future actual premiums and consideration charged for such contract.

(5) Reserves required to be maintained to provide for the ordinary operating expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage.

(6) Liability for premiums received in advance.

(7) Liability for premium deposit funds.

(8) Liability for annual and deferred dividends declared or apportioned.

(9) Liability for dividends left on deposit at interest.

(10) Liability for accrued but unsettled policy claims whether known or unreported.

(11) A mandatory securities valuation reserve.

(f) *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

[T.D. 6513, 25 FR 12656, Dec. 10, 1960, as amended by T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§ 1.801–5 Total reserves.

(a) *Total reserves defined.* For purposes of section 801(a) and § 1.801–3, the term ''total reserves'' is defined in section 801(c) as the sum of:

(1) Life insurance reserves (as defined in section 801(b) and § 1.801–4),

(2) Unearned premiums (as defined in paragraph (e) of § 1.801–3), and unpaid losses (whether or not ascertained) (as defined in paragraph (g) of § 1.801–3), not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The term ''total reserves'' does not, however, include deficiency reserves (within the meaning of section 801(b)(4), and paragraph (e)(4) of § 1.801–4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any

State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed. For example, during the taxable year 1958 a life insurance company sells life insurance and annuity contracts in States A and B. State A requires reserves of 10 against the life and 5 against the annuity business. State B requires reserves of 9 against the life and 7 against the annuity business. Assuming the company actually holds these reserves during the taxable year 1958, its highest aggregate reserve for such taxable year is the 16 required by State B. Thus, the company is not permitted to compute its highest aggregate reserve by taking State A's requirement of 10 against its life insurance business and adding it to State B's requirement of 7 against its annuity business.

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term *reserves required by law* means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

(c) *Information to be filed.* In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. See section 6012 and paragraph (c) of §1.6012–2. If the basis (for Federal income tax purposes) for determining the amount of any of the life insurance reserves as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year then the following information must be filed with respect to all such changes in basis:

(1) The nature of the life insurance reserve (i.e., life, annuity, etc.);

(2) The mortality or morbidity table, assumed rate of interest, method used in computing or estimating such reserve on the old basis, and the amount of such reserve at the beginning and close of the taxable year computed on the old basis;

(3) The mortality or morbidity table, assumed rate of interest, method used in computing or estimating such reserve on the new basis, and the amount of such reserve at the close of the taxable year computed on the new basis;

(4) The deviation, if any, from recognized mortality or morbidity tables, or recognized methods of computation;

(5) The reasons for the change in basis of such reserve; and

(6) Whether such change in the reserve has been approved or accepted by the regulatory authorities of the State of domicile, and if so, a copy of the letter, certificate, or other evidence of such approval or acceptance.

(d) *Illustration of principles.* The provisions of section 801 relating to the percentage requirements for qualification as a life insurance company may be illustrated by the following example:

Example. The books of Y, an insurance company, selling life insurance, noncancellable health and accident insurance, and cancellable accident and health insurance, reflect (after adjustment under sections 806(a) and 801(d)) the following facts for the taxable year 1958:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	$3,000	$5,000	$4,000
2. Unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable accident and health insurance not included in life insurance reserves	400	600	500
3. Unearned premiums, and unpaid losses (whether or not ascertained), on cancellable accident and health insurance	1,800	2,200	2,000
4. All other insurance reserves required by law	900	1,100	1,000
5. Total reserves	....	....	7,500

The rules provided by section 801 require that the sum of the mean of the year figures in items 1 and 2 comprise more than 50 percent of the mean of the year figure in item 5 for an insurance company to qualify as a life insurance company. Thus, Y would qualify as a life insurance company for the taxable year 1958 as the sum of the mean of the year figures in items 1 and 2 ($4,500) comprise 60 percent of the mean of the year figure in item 5 ($7,500).

[T.D. 6513, 25 FR 12657, Dec. 10, 1960]

§ 1.801–6 Adjustments in reserves for policy loans.

(a) *In general.* Section 801(d) provides that for purposes only of determining whether or not an insurance company is a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), the life insurance reserves (as defined in section 801(b) and § 1.801–4), and the total reserves (as defined in section 801(c) and paragraph (a) of § 1.801–5), shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained. Such reduction shall be made after any adjustments required under section 806(a) and § 1.806–3 have been made.

(b) *Policy loans defined.* The term *policy loans* includes loans made by the insurance company, by whatever name called, for which the reserve on a contract is the collateral.

(c) *Illustration of principles.* The provisions of section 801(d) and this section may be illustrated by the following example:

Example. The books of T, an insurance company, selling only life insurance and cancellable accident and health insurance, reflect (after adjustment under section 806 (a)) the following facts for the taxable year 1958:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	$1,000	$2,000	$1,500
2. Policy loans	50	850	450
3. Life insurance reserves less policy loans	....	....	1,050
4. Unearned premiums, and unpaid losses (whether or not ascertained), on cancellable accident and health insurance	900	1,600	1,250
5. Total reserves adjusted for policy loans (item 3 plus item 4)	....	....	2,300

As the rules provided by section 801 (a) and (d) require that the figure in item 3 ($1,050) be more than 50 percent of the mean of the year figure in item 5 ($2,300) for an insurance company to qualify as a life insurance company, T would not qualify as a life insurance company for the taxable year 1958.

[T.D. 6513, 25 FR 12657, Dec. 10, 1960]

§ 1.801–7 Variable annuities.

(a) *In general.* (1) Section 801(g)(1) provides that for purposes of part I, subchapter L, chapter 1 of the Code, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing such a contract. A variable annuity differs from the ordinary or fixed dollar annuity in that the annuity benefits payable under a variable annuity contract vary with the insurance company's investment experience with respect to such contracts while the annuity benefits paid under a fixed dollar annuity contract are guaranteed irrespective of the company's actual investment earnings.

(2) The reserves held with respect to the annuity contracts described in section 801(g)(1) and subparagraph (1) of this paragraph shall qualify as life insurance reserves within the meaning of section 801(b)(1) and paragraph (a) of § 1.801–4 provided such reserves are required by law (as defined in paragraph (b) of § 1.801–5) and are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from such contracts involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Accordingly, a company issuing variable annuity contracts shall qualify as a life insurance company for Federal income tax purposes if it satisfies the requirements of section 801(a) (relating to the definition of a life insurance company) and paragraph (b) of § 1.801–3.

(b) *Special rules for variable annuities*—(1) *Adjusted reserves rate; assumed rate.* The adjusted reserves rate for any taxable year with respect to the annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section, and the rate of interest assumed by the taxpayer for any taxable year in calculating the reserve on any such contract, shall be a rate equal to the current earnings rate determined under section 801(g)(3) and subparagraph (2) of this paragraph. However, any change in the rate of interest assumed by the taxpayer in calculating the reserve on a variable annuity contract for any taxable year which is attributable to an increase or decrease in the current earnings rate, shall not be treated as a change of basis in computing reserves for purposes of section 806(b) (relating to certain changes in reserves) or section 810 (d)(1) (relating to adjustment for change in computing reserves).

(2) *Current earnings rate.* (i) The current earnings rate for any taxable year with respect to the annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section shall be the current earnings rate determined under section 805(b)(2) and paragraph (a)(2) of § 1.805–5 with respect to such contracts, reduced by the percentage obtained by dividing *(a)* the amount of the actuarial margin charge on all such variable annuity contracts issued by the taxpayer, by *(b)* the mean of the reserves for such contracts.

(ii) For purposes of section 801(g)(3) and subdivision (i) of this subparagraph, the term *actuarial margin charge* means any amount retained by the company from gross investment income pursuant to the terms of the variable annuity contract in excess of any portion of the investment expenses which is attributable to such contract and which is deductible under section 804(c) and paragraph (b) of § 1.804–4.

(3) *Increases and decreases in reserves.* (i) Section 801(g)(4) provides that for purposes of section 810 (a) and (b) (relating to adjustments for increases or decreases in certain reserves), the sum of the items described in section 810(c) and paragraph (b) of § 1.810–2 taken into account as of the close of the taxable year shall be adjusted:

(a) By subtracting therefrom the sum of any amounts added from time to time (for the taxable year) to the reserves for variable annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section by reason of realized or unrealized appreciation in the value of the assets held in relation thereto, and

(b) By adding thereto the sum of any amounts subtracted from time to time (for the taxable year) from such reserves by reason of realized or unrealized depreciation in the value of such assets.

(ii) The application of section 801(g)(4) and subdivision (i) of this subparagraph may be illustrated by the following example:

Example. Company M, a life insurance company issuing only variable annuity contracts of the type described in section 801(g)(1) and paragraph (a)(1) of this section, increased its life insurance reserves held with respect to such contracts during the taxable year 1959 by $275,000. Of the total increase in the reserves, $100,000 was attributable to premium receipts, $50,000 to dividends and interest, $100,000 to unrealized appreciation in the value of the assets held in relation to such reserves, and $25,000 to realized capital gains on the sale of such assets. As of the close of the taxable year 1959, the reserves held by company M with respect to all variable annuity contracts amounted to $1,275,000. However, under section 801(g)(4) and subdivision (i) of this subparagraph, this amount must be reduced by the $100,000 unrealized asset value appreciation and the $25,000 of realized capital gains. Accordingly, for purposes of section 810 (a) and (b), the amount of these reserves which is to be taken into account as of the close of the taxable year 1959 under section 810(c) is $1,150,000 ($1,275,000 less $125,000).

(c) *Companies issuing variable annuities and other contracts.* (1) In the case of a life insurance company which issues both annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section and other contracts, the policy and other contract liability requirements (as defined in section 805(a) and paragraph (b) of § 1.805–4) of such a company for any taxable year shall be considered to be the sum of:

(i) The policy and other contract liability requirements computed with respect to the items which relate to such variable annuity contracts, and

(ii) The policy and other contract liability requirements computed by excluding the items taken into account under subdivision (i) of this subparagraph.

(2) [Reserved for regulations to be issued under section 801(g)(5)(B).]

(d) *Termination.* Paragraphs (1), (2), (3), (4), and (5) of section 801(g) and paragraphs (a), (b), (c), and (d) of this section shall not apply with respect to any taxable year beginning after December 31, 1962.

[T.D. 6610, 27 FR 8717, Aug. 31, 1962]

§ 1.801–8 Contracts with reserves based on segregated asset accounts.

(a) *Definitions*—(1) *Annuity contracts include variable annuity contracts.* Section 801(g)(1)(A) provides that for purposes of part I, subchapter L, chapter 1 of the Code, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing such a contract. A variable annuity differs from the ordinary or fixed dollar annuity in that the annuity benefits payable under a variable annuity contract vary with the insurance company's investment experience with respect to such contracts while the annuity benefits paid under a fixed dollar annuity contract are guaranteed irrespective of the company's actual investment earnings.

(2) *Contracts with reserves based on a segregated asset account.* (i) For purposes of part I, section 801(g)(1)(B) defines the term *contract with reserves based on a segregated asset account* as a contract (individual or group):

(a) Which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

(b) Which provides for the payment of annuities, and

(c) Under which the amounts paid in, or the amount paid as annuities, reflect the investment return and the market value of the segregated asset account.

(ii) The term *contract with reserves based on a segregated asset account* includes a contract such as a variable annuity contract, which reflects the investment return and the market value of the segregated asset account, even though such contract provides for the payment of an annuity computed on the basis of recognized mortality tables, but the term includes such contract only for the period during which it satisfies the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph. However, such term does not include a pension contract written on the basis of the so-called new-money concept. Thus, for example, such term does not include a pension contract whereby reserves are credited on the basis of the company's new high yield investments. Furthermore, such term does not include a contract which during the taxable year contains a right to participate in the divisible surplus of the company where such right merely reflects the company's investment return. Nevertheless, the term does include a contract which meets the requirements of section 801(g)(1)(B) and of this subparagraph even if part of the amounts received are, for example, allocated to reserves under provisions of the contract which are written on the basis of the new-money concept. However, such reserves do not qualify as a segregated asset account referred to in section 801(g) and this section.

(iii) If at any time during the taxable year a contract otherwise satisfying the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of section 801(g)(1)(B)(iii) and subdivision (i) *(c)* of this subparagraph after such cessation. Thus, a contract with reserves based on a segregated asset account includes a contract under which the reflection of investment return and market value terminates at the beginning of the annuity payments, but only for the period prior to such termination. For example, if the purchaser of a variable annuity contract which meets such requirements elects an option which provides for the payment of a fixed dollar annuity, then such contract shall be considered as satisfying such requirements only for the period prior to the time such contract ceases to reflect current investment return and current market value. Furthermore, a group annuity contract which satisfies the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph shall be considered as continuing to meet such requirements even though a certificate holder under the group contract elects an option which provides for the payment of a fixed dollar annuity. However, the annuity attributable to such certificate holder shall not be considered as satisfying such requirements as of the time such annuity ceases to reflect current investment return and current market value. On the other hand, a group annuity contract which does not reflect current market value shall not be considered as satisfying such requirements even though a certificate holder under the group contract elects an option which provides for the payment of a variable annuity. However, the variable annuity attributable to such certificate holder shall be considered as satisfying such requirements as of the time such variable annuity commences to reflect current investment return and current market value.

(b) *Life insurance reserves.* Section 801(g)(2) provides that for purposes of section 801(b)(1)(A), the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest. Thus, the reserves held with respect to contracts described in section 801(g)(1) and paragraph (a) of this section shall qualify as life insurance reserves within the meaning of section 801(b)(1) and paragraph (a) of §1.801–4 provided such reserves are required by law (as defined in paragraph (b) of §1.801–5) and are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from such contracts with reserves based on segregated asset accounts involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Accordingly, a company issuing contracts with reserves based on segregated asset accounts shall qualify as a life insurance company for Federal income tax purposes if it satisfies the requirements of section 801(a) (relating to the definition of a life insurance company) and paragraph (b) of §1.801–3.

(c) *Separate accounting.* (1) For purposes of part I, section 801(g)(3) provides that a life insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3) which issues contracts with reserves based on segregated asset accounts (as defined in section 801 (g)(1)(B) and paragraph (a)(2) of this section) shall separately account for each and every income, exclusion, deduction, asset, reserve, and other liability item which is properly attributable to such segregated asset accounts. In those cases where such items are not directly accounted for, separate accounting shall be made:

(i) According to the method regularly employed by the company, if such method is reasonable, and

(ii) In all other cases in a manner which, in the opinion of the district director, is reasonable.

A method of separate accounting for such items as are not accounted for directly will be deemed ''regularly employed'' by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before issued contracts with reserves based on segregated asset accounts, the company initiates in the first taxable year for which it issues such contracts a reasonable method of separate accounting for such items and consistently follows such method thereafter. Ordinarily, a company regularly employs a method of accounting in accordance with the statute of the State, Territory, or the District of Columbia, in which it operates.

(2) Every life insurance company issuing contracts with reserves based on segregated asset accounts shall keep such permanent records and other data relating to such contracts as is necessary to enable the district director to determine the correctness of the application of the rules prescribed in section 301(g) and this section and to ascertain the accuracy of the computations involved.

(d) *Investment yield.* (1) For purposes of part I, section 801(g)(4)(A) provides that the policy and other contract liability requirements (as determined under section 805), and the life insurance company's share of investment yield (as determined under sections 804(a) or 809(b)), shall be separately computed:

(i) With respect to the items separately accounted for in accordance with section 801(g)(3) and paragraph (c) of this section, and

(ii) Excluding the items taken into account under subdivision (i) of this subparagraph.

Thus, for purposes of determining both taxable investment income and gain or loss from operations, a life insurance company shall separately compute the life insurance company's share of the investment yield on the assets in its segregated asset account without regard to the policy and other contract liability requirements of, and the investment income attributable to, contracts with reserves that are not based on the segregated asset account. Such separate computations shall be made after any allocation required under section 801(g)(4)(B) and subparagraph (2) of this paragraph.

(2)(i) Section 801(g)(4)(B) provides that if the net short-term capital gain (as defined in section 1222(5)) exceeds the net long-term capital loss (as defined in section 1222(8)), determined without regard to any separate computations under section 801(g)(4)(A) and subparagraph (1) of this paragraph, then such excess shall be allocated between section 801(g)(4)(A) (i) and (ii) and subparagraph (1) (i) and (ii) of this paragraph. Such allocation shall be in proportion to the respective contributions to such excess of the items taken into account under each such section and subparagraph. The allocation under this subparagraph shall be made before the separate computations prescribed by section 801(g)(4)(A) and subparagraph (1) of this paragraph.

(ii) The operation of the allocation required under section 801(g)(4)(B) and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. For the taxable year 1962, T, a life insurance company which issues regular life insurance and annuity contracts and contracts with reserves based on segregated asset accounts, had (without regard to section 801(g)(4)(A)) realized short-term capital gains of $10,000 and short-term capital losses of $10,000 attributable to its general asset accounts and realized short-term capital gains of $12,000 attributable to its segregated asset accounts. For the taxable year 1962, the excess of the net short-term capital gain ($10,000+$12,000−$10,000, or $12,000) over the net long-term capital loss (0) was $12,000. Of the excess of $12,000, 100 percent was contributed by the segregated asset accounts. Applying the provisions of section 801(g)(4)(B), T would allocate the entire $12,000 to its segregated asset accounts for such taxable year.

Example 2. The facts are the same as in example 1 except that for the taxable year 1962, T had (without regard to section 801(g)(4)(A)) realized short-term capital losses of $8,000 attributable to its general asset accounts and realized long-term capital gains of $1,000 and long-term capital losses of $5,000 attributable to its segregated asset accounts. For the taxable year 1962, the excess of the net short-term capital gain ($10,000+$12,000−$8,000, or $14,000) over the net long-term capital loss ($5,000−$1,000, or $4,000) was $10,000. Of the excess of $10,000, the general asset accounts contributed 20 percent ($2,000 ($10,000−$8,000)÷$10,000) and the segregated asset accounts contributed 80 percent ($8,000 ($12,000−$4,000)÷$10,000). Applying the provisions of section 801(g)(4)(B), T would allocate $2,000 ($10,000×20 percent) to its general asset accounts and $8,000 ($10,000×80 percent) to its segregated asset accounts for such taxable year.

Example 3. W is a life insurance company which issues regular life insurance and annuity contracts and contracts with reserves based on either of two segregated asset accounts, Separate Account C or Separate Account D. For the taxable year 1962, W had (without regard to section 801(g)(4)(A)) realized short-term capital gains of $16,000 and long-term capital losses of $15,000 attributable to its general asset accounts, long-term capital gains of $12,000 and short-term capital losses of $6,000 attributable to Separate Account C and long-term capital gains of $7,000 and short-term capital losses of $5,000 attributable to Separate Account D. For the taxable year 1962, the excess of the net short-term capital gain ($16,000−$6,000−$5,000) over the net long-term capital loss (0) was $5,000. Of the $5,000 excess, 20 percent ($16,000−$15,000÷$5,000) was contributed by the general asset accounts, leaving 80 percent as the amount contributed by the segregated asset accounts. Applying the provisions of section 801(g)(4)(B) W would allocate $1,000 (20 percent of $5,000) to the general asset accounts, leaving $4,000 (80 percent of $5,000) to be allocated among the segregated asset accounts, Separate Account C and Separate Account D. W would allocate $3,000 of the $4,000 to Separate Account C computed as follows:

$$\$3{,}000 = \frac{(\$4{,}000)\times(\$12{,}000-\$6{,}000)}{(\$12{,}000-\$6{,}000)+(\$7{,}000-\$5{,}000)}$$

W would allocate $1,000 of the $4,000 to Separate Account D computed as follows:

$$\$1{,}000 = \frac{(\$4{,}000)\times(\$7{,}000-\$5{,}000)}{(\$12{,}000-\$6{,}000)+(\$7{,}000-\$5{,}000)}$$

(e) *Policy and other contract liability requirements.* (1) For purposes of part I, section 801(g)(5)(A) provides that with respect to life insurance reserves based on segregated asset accounts (as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section), the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed by the taxpayer for purposes of sections 805(c) and 809(a)(2), shall be a rate equal to the current earnings rate determined under section 805(b)(2) and paragraph (a)(2) of § 1.805–5 with respect to the items separately accounted for in accordance with section 801(g)(3), reduced by the percentage obtained by dividing:

(i) Any amount retained with respect to all of the reserves based on a segregated asset account by the life insurance company from gross investment income (as defined in section 804(b) and paragraph (a) of § 1.804–3) on segregated assets, to the extent such retained amount exceeds the deductions allowable under section 804(c) which are attributable to such reserves, by

(ii) The means of such reserves.

(2) For purposes of part I, section 801 (g)(5)(B) provides that with respect to reserves based on segregated asset accounts other than life insurance reserves, there shall be included as interest paid within the meaning of section 805(e)(1) and paragraph (b)(1) of § 1.805–8, an amount equal to the product of the means of such reserves multiplied by the rate of interest assumed as defined in section 801(g)(5)(A) and subparagraph (1) of this paragraph.

(3) For purposes of this paragraph, any change in the rate of interest assumed by the taxpayer in calculating the reserve on a contract with reserves based on a segregated asset account for any taxable year beginning after December 31, 1961, which is attributable to an increase or decrease in the current earnings rate, shall not be treated as a change of basis in computing reserves for purposes of section 806(b) (relating to certain changes in reserves) or section 810 (d)(1) (relating to adjustment for change in computing reserves).

(4) The provisions of section 801(g) (3) through (5) may be illustrated by the following example. For purposes of this example, it is assumed that all computations have been carried out to a sufficient number of decimal places to insure substantial accuracy and to eliminate any significant error in the resulting tax liability.

Example. The books of R, a life insurance company, discloses the following facts with respect to items of investment yield, deductions, assets, and reserves for the taxable year 1962:

(a) *Excerpts from Company Financial Statements.*

(1) Investment yield	Company regular account	Separate account A	Separate account B
Interest wholly tax-exempt	$100,000	$3,000	$1,000
Interest—other	10,000,000	8,000	15,000
Dividends received	200,000	25,000	27,000
Other items of investment yield	100,000	2,000	1,000
Gross investment income	10,400,000	38,000	44,000
Less deductions (sec. 804(c))	1,000,000	4,000	4,400
Investment yield	9,400,000	34,000	39,600
(2) Assets and reserves:			
(i) Assets:			
Jan. 1, 1962	190,000,000		
Dec. 31, 1962	210,000,000	1,600,000	1,800,000
Mean	200,000,000	800,000	900,000
(ii) Life insurance reserves:			
Jan. 1, 1962	152,000,000		
Dec. 31, 1962	168,000,000	1,600,000	1,640,000
Mean	160,000,000	800,000	820,000
(iii) Reserves based on segregated asset accounts other than life insurance reserves:			
Jan. 1, 1962			
Dec. 31, 1962			120,000
Mean			60,000

(b) *Additional facts.* In addition to the facts assumed in (a) above, assume the following: The company retained with respect to reserves based upon segregated asset accounts a total of $4,720 from gross investment income on Separate Account A and $5,720 from gross investment income on Separate Account B. With respect to the Company Regular Account computed without regard to the items in either of the separate accounts, the policy and other contract liability requirement is $6,580,000 and the required interest is $5,640,000. There are no items of interest paid with respect to the separate accounts other than those computed under section 801(g)(5)(B). Based on these facts, the current earnings rate (sec. 805(b)); adjusted reserves rate (sec. 805 (b)); and rate of interest assumed (secs. 805(c) and 809(a)(2)); and the policy and other contract liability requirements are determined for each of the Separate Accounts A and B (and the policy and other contract liability requirements for the Company Regular Account) as set forth in items (c) through (1) below.

(c) *Separate Account A.* The current earnings rate determined under section 805 (b)(2) with respect to the items separately accounted for under Separate Account A, prior to the reduction provided for under section 801(g)(5)(A), is 4.25 percent (the investment yield, $34,000, divided by the mean of the assets, $800,000). The company retained with respect to such reserves from gross investment income on Separate Account A a total of $4,720. The company had deductions allowable under section 804(c) with respect to such account of $4,000. Accordingly, for purposes of section 801(g)(5)(A)(i), the amount retained by the company was $720 (the total amount retained of $4,720 less the deductions allowable under section 804(c) of $4,000). The reduction percentage for purposes of section 801(g)(5)(A) is 0.09 percent (the amount retained of $720 divided by the mean of the life insurance reserves of $800,000). Therefore, the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed for purposes of sections 805(c) and 809(a)(2) is equal to 4.16 percent (the current earnings rate of 4.25 percent less the reduction percentage of 0.09 percent).

The policy and other contract liability requirements with respect to Separate Account A is determined as follows: For purposes of section 805(a) (1) and (2), the amount is $33,280 (the mean of the life insurance reserves, $800,000, multiplied by the current earnings rate, as determined under section 801(g)(5)(A), 4.16 percent). Thus, the policy and other contract liability requirement for Separate Account A is $33,280.

(d) *Separate Account B.* The current earnings rate determined under section 805 (b)(2) with respect to the items separately accounted for under Separate Account B, prior to the reduction provided for under section 801(g)(5)(A), is 4.40 percent (the investment yield, $39,600 divided by the mean of the assets, $900,000). The company retained with respect to such reserves from gross investment income on Separate Account B a total of $5,720. The company had deductions allowable under section 804(c) with respect to such account of $4,400. Accordingly, for purposes of section 801(g)(5)(A)(i) the amount retained by the company was $1,320 (the total amount retained of $5,720 less the deductions allowable under section 804(c) of $4,400). The reduction percentage for purposes of section 801(g)(5)(A) is 0.15 percent (the amount retained of $1,320 divided by the mean of the reserves based on Separate Account B of $880,000 ($820,000 plus $60,000)). Therefore, the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed for purposes of section 805(c) and 809(a)(2) is equal to 4.25 percent (the current earnings rate of 4.40 percent less the reduction percentage of 0.15 percent).

With respect to reserves based on segregated asset accounts other than life insurance reserves, Separate Account B had such reserves at December 31, 1962, of $120,000. The mean of such reserves was $60,000. The rate of interest assumed with respect to such reserves is 4.25 percent, as computed above. Accordingly, there shall be included as interest paid within the meaning of section 805(e)(1) the amount of $2,550 (the mean of such reserves, $60,000 multiplied by the rate of interest assumed of 4.25 percent).

The policy and other contract liability requirements with respect to Separate Account B is determined as follows:

(1) For purposes of section 805(a)(1) and (2), the amount is $34,850 (the mean of the life insurance reserves, $820,000, multiplied by the current earnings rate, as determined under section 801(g)(5)(A), 4.25 percent).

(2) For purposes of section 805(a)(3), the amount is $2,550 (the mean of the reserves based on Separate Account B other than life insurance reserves, $60,000, multiplied by the rate of interest assumed, as determined under section 801(g)(5)(A), 4.25 percent). It has been assumed that there was no other interest paid on Separate Account B within the meaning of section 805(e). If there was other interest paid with respect to Separate Account B that met the requirements of section 805(e), however, then such interest would be included under section 805(a)(3). Thus, the policy and other contract liability requirement for Separate Account B is $37,400 ($34,850+$2,550).

(e) *Company Regular Account.* The policy and other contract liability requirements with respect to the Company Regular Account is $6,580,000 (this amount is determined by the company in the manner provided by section 805 (and the regulations thereunder) without regard to either Separate Account A or Separate Account B).

(f) *Policyholders' share and company's share of investment yield—section 804.* The policyholders' and company's share of investment yield and taxable investment income are computed as follows:

(1) Company Regular Account

Policyholders' share of investment yield.	70% ($6,580,000÷$9,400,000).
Company's share of investment yield (100% less 70%).	30%.

(2) Separate Account A

Policyholders' share of investment yield.	97.8824% ($33,280 ÷$34,000).
Company's share of investment yield (100% less 97.8824%).	2.1176%.

(3) Separate Account B

Policyholders' share of investment yield.	94.444% ($37,400 ÷$39,600).
Company's share of investment yield (100% less 94.444%).	5.556%.

(g) *The company's share of investment yield under section 804 is determined as follows:*

Investment yield (from item (a)(1))	Company regular account (30 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item (a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Interest wholly tax-exempt	$30,000	$63.53	$55.56
Interest—other	3,000,000	169.41	833.40
Dividends received	60,000	529.40	1,500.12
Other items of gross investment income.	30,000	42.35	55.56
	3,120,000	804.69	2,444.64
Less deductions	300,000	84.70	244.46
Investment yield	2,820,000	719.99	2,200.18

(h) *Taxable investment income.* The company's taxable investment income (without regard to any excess of net long-term capital gain over net short-term capital loss) is determined as follows:

Life insurance company's share of investment yield ($2,820,000+$719.99+ $2,200.18)	$2,822,920.17
Less:	
Company's share of interest wholly tax-exempt ($30,000+ $63.53+$55.56)=$30,119.09	
85 percent of company's share of dividends received (but not to exceed 85% of taxable investment income computed without regard to this deduction) (85%×$62,029.52) ($60,000+ $529.40+$1,500.12)=$52,725.09	
Small business deduction (10% of investment yield, $9,473,600, not to exceed $25,000) =$25,000.00	107,844.18
Taxable investment income	2,715,075.99

(i) *Required interest—section 809(a)(2)*— (1) *Separate Account A.* The rate of interest assumed by the company, with respect to Separate Account A is 4.16 percent (see (c) above). The required interest for purposes of section 809(a)(2) is determined as follows:

Life insurance reserves: 4.16% (rate assumed) times $800,000 (mean of life insurance reserves)	$33,280.00

(2) *Separate Account B.* The rate of interest assumed by the company with respect to Separate Account B is 4.25 percent (see (d) above). The required interest for purposes of section 809(a)(2) is determined as follows:

(i) Life insurance reserves: 4.25% (rate assumed) times $820,000 (mean of life insurance reserves)	$34,850.00
(ii) Other section 810(c) reserves: 4.25% (rate assumed) times $60,000 (mean of reserves other than life insurance reserves)	$2,550.00
	$37,400.00

(3) *Company Regular Account.* The required interest with respect to the Company Regular Account is $5,640,000 (this amount is assumed for purposes of this example, but it would be determined by the company in the manner provided by section 809 without regard to either Separate Account A or Separate Account B).

(j) *Policyholders' share and company's share of investment yield—section 809.* The policyholders' share and the company's share of investment yield for purposes of section 809 is determined as follows:

(1) *Company Regular Account:*	
Policyholders' share of investment yield	60% ($5,640,000÷$9,400,000).
Company's share of investment yield (100 percent—60%).	40%.
(2) *Separate Account A:*	
Policyholders' share of investment yield	97.8824% ($33,280÷$34,000).
Company's share of investment yield (100%—97.8824 percent).	2.1176%.
(3) *Separate Account B:*	
Policyholders' share of investment yield	94.444% ($37,400÷$39,600).
Company's share of investment yield (100%—94.444%).	5.556%.

(k) *The company's share of investment yield under section 809 is determined as follows:*

Investment yield (from item (a)(1))	Company regular account (40 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item (a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Interest wholly tax-exempt	$40,000	$63.53	$55.56
Interest—other	4,000,000	169.41	833.40
Dividends received	80,000	529.40	1,500.12
Other items of gross investment income	40,000	42.35	55.56
	4,160,000	804.69	2,444.64
Less deductions	400,000	84.70	244.46
Investment yield	3,760,000	719.99	2,200.18

(l) *Deductions under section 809(d)(8).* For purposes of section 809(d)(8), the life insurance company's share of each of such items is determined as follows:

(1) Wholly tax-exempt interest ($40,000+$63.53+$55.56)	$40,119.09
(2) Dividends received 85%× $82,029.52 ($80,000+$529.40+$1,500.12) (it is assumed for purposes of this example that this amount does not exceed 85% of the gain from operations as computed under sec. 809(d)(8)(B))	69,725.09

(f) *Increases and decreases in reserves.* (1) Section 801(g)(6) provides that for purposes of section 810 (a) and (b) (relating to adjustments for increases or decreases in certain reserves), the sum of the items described in section 810(c) and paragraph (b) of § 1.810–2 taken into account as of the close of the taxable year shall be adjusted:

(i) By subtracting therefrom the sum of any amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with section 801(g)(3) and paragraph (c) of this section by reason of realized or unrealized appreciation in value of the assets held in relation thereto, and

(ii) By adding thereto the sum of any amounts subtracted from time to time (for the taxable year) from such reserves by reason of realized or unrealized depreciation in the value of such assets.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Company M, a life insurance company issuing only contracts with reserves based on segregated asset accounts as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section (other than contracts described in section 805(d)(1) (A), (B), (C), or (D)), increased its life insurance reserves held with respect to such contracts during the taxable year 1962 by $275,000. Of the total increase in the reserves, $100,000 was attributable to premium receipts, $50,000 to dividends and interest, $100,000 to unrealized appreciation in the value of the assets held in relation to such reserves, and $25,000 to realized capital gains on the sale of such assets. As of the close of the taxable year 1962, the reserves held by company M with respect to all such contracts amounted to $1,275,000. However, under section 801(g)(6) and this subparagraph, this amount must be reduced by the $100,000 unrealized asset value appreciation and the $25,000 of realized capital gains. Accordingly, for purposes of section 810(a) and (b), the amount of these reserves which is to be taken into account as of the close of the taxable year 1962 under section 810(c) is

$1,150,000 ($1,275,000 less $125,000). However, for purposes of section 810 (a) and (b), the amount of these reserves which is to be taken into account as of the beginning of the taxable year 1963 under section 810(c) is $1,275,000 (the amount as of the close of the taxable year 1962 before reduction of $125,000 for unrealized appreciation and realized capital gains).

(3)(i) Under section 801(g)(6), the deduction allowable for items described in section 809(d) (1) and (7) (relating to death benefits and assumption reinsurance, respectively) with respect to segregated asset accounts shall be reduced to the extent that the amount of such items is increased for the taxable year by appreciation (or shall be increased to the extent that the amount of such items is decreased for the taxable year by depreciation) not reflected in adjustments required to be made under subparagraph (1) of this paragraph.

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

Example. On June 30, 1962, X, a life insurance company, reinsured a portion of its insurance contracts with reserves based on segregated asset accounts with Y, a life insurance company, under an agreement whereby Y agreed to assume and become solely liable under the contracts reinsured. The reserves on the contracts reinsured by X were $90,000, of which $10,000 was attributable to unrealized appreciation in the value of the assets held in relation to such reserves. However, no amounts had been added to the reserves by reason of the unrealized appreciation of $10,000 and consequently, the $10,000 was not reflected in adjustments to reserves under section 809(g)(6) or subparagraph (1) of this paragraph. Under the reinsurance agreement, X made a payment of $90,000 in cash to Y for assuming such contracts. Applying the provisions of section 809(d)(7), and assuming no other such reinsurance transactions by X during the taxable year, X would have an allowable deduction of $90,000 as a result of this payment on June 30, 1962. However, applying the provisions of section 801(g)(6) and this subparagraph, the actual deduction allowed would be $80,000 ($90,000 less $10,000). See section 806 (a) and § 1.806–3 for the adjustments in reserves and assets to be made by X and Y as a result of this transaction. For the treatment by Y of this $90,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809–4.

(g) *Basis of assets held for certain pension plan contracts.* Section 801(g)(7) provides that in the case of contracts described in section 805(d)(1) (A), (B), (C), (D), or (E) (relating to the definition of pension plan reserves), the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be (i) increased by the amount of any appreciation in value, and (ii) decreased by the amount of any depreciation in value; but only to the extent that such appreciation and depreciation are reflected in the increases and decreases in reserves, or other items described in section 801(g)(6), with respect to such contracts. Thus, there shall be no capital gains tax payable by a life insurance company on appreciation realized on assets in a segregated asset account to the extent such appreciation has been reflected in reserves, or other items described in section 801(g)(6), for contracts described in section 805(d)(1) (A), (B), (C), (D), or (E) based on segregated asset accounts.

(h) *Additional separate computation*—(1) *Assets and total insurance liabilities.* A life insurance company which issues contracts with reserves based on segregated asset accounts (as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section) shall separately compute and report with its return the assets and total insurance liabilities which are properly attributable to all of such segregated asset accounts. Each foreign corporation carrying on a life insurance business which issues such contracts shall separately compute and report with its return assets held in the United States and total insurance liabilities on United States business which are properly attributable to all of such segregated asset accounts.

(2) *Foreign life insurance companies.* For adjustment under section 819 in the case of a foreign life insurance company which issues contracts based on segregated asset accounts under section 801(g), see § 1.819–2(b)(4).

[T.D. 6886, 31 FR 8681, June 23, 1966, as amended by T.D. 6970, 33 FR 12044, Aug. 24, 1968; T.D. 7501, 42 FR 42341, Aug. 23, 1977]

§ 1.802(b)–1 Tax on life insurance companies.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, section 802(b) imposes a tax on the 1954 life insurance company taxable income of all life insurance companies (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801). The tax so imposed is equal to 3 3/4 percent of the amount of such income not in excess of $200,000, plus 6 1/2 percent of the amount of such income in excess of $200,000. For the definition of the term ''1954 life insurance company taxable income'', see § 1.805–1.

(b) The taxable income of life insurance companies differs from the taxable income of other corporations. See section 803. Life insurance companies are entitled, in computing life insurance company taxable income, to the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. The gross income, the deduction under section 803 (g)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 803 (i) and § 1.803–6. Such companies are not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code, relating to capital gains and losses, nor to the provisions of section 171 (amortizable bond premium).

(c) All provisions of the Code and of the regulations in this part not inconsistent with the specific provision of sections 801 to 807, inclusive, are applicable to the assessment and collection of the tax imposed by section 802, and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(d) Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

§ 1.802–2 Taxable years affected.

Section 1.802(b)–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.802–3 through 1.802–5 (other than paragraph (f)(2) of § 1.802–3), except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 235(c)(1) of the Revenue Act of 1964 (78 Stat. 126). Paragraph (f)(2) of § 1.802–3 is applicable only to taxable years beginning after December 31, 1961, and all reference to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), section 3 of the Act of October 23, 1962 (76 Stat. 1134) and section 235(c)(1) of the Revenue Act of 1964 (78 Stat. 126).

[T.D. 6886, 31 FR 8685, June 23, 1966]

§ 1.802–3 Tax imposed on life insurance companies.

(a) *In general.* For taxable years beginning after December 31, 1957, section 802(a)(1) imposes a tax on the life insurance company taxable income (as defined in section 802(b) and paragraph (a) of § 1.802–4) of every life insurance company (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801(a)). The tax imposed by section 802(a)(1) is payable upon the basis of returns rendered by the life insurance companies liable thereto. See subchapter A, chapter 61 (section 6001 and following) of the Code.

(b) *Tax imposed.* The tax imposed by section 802(a)(1) consists of a normal tax and a surtax computed as provided in section 11 as though the life insurance company taxable income (as defined in section 802(b)) were the taxable income referred to in section 11.

(c) *Normal tax.* The normal tax is computed by applying to the life insurance company taxable income the regular corporate normal tax rate (as in effect for the taxable year) provided by section 11(b).

(d) *Surtax.* The surtax is computed by applying the regular corporate surtax rate (as in effect for the taxable year) provided by section 11(c) to the amount by which the life insurance company taxable income exceeds the surtax exemption for the taxable year as determined under section 11(d). See sections 269 and 1551 and the regulations thereunder, for certain circumstances in which the surtax exemption may be disallowed in whole or in part.

(e) *Special rule for 1959 and 1960.* See section 802(a)(3) and paragraph (a) of §1.802–5 for a transitional rule applicable in certain cases in determining tax liability for the taxable years 1959 and 1960 by reason of the operation of section 802(b)(3).

(f) *Tax imposed in case of certain capital gains*—(1) *Taxable years beginning after December 31, 1958, and before January 1, 1962.* For taxable years beginning after December 31, 1958, and before January 1, 1962, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) imposes a separate tax equal to 25 percent of such excess. This separate 25 percent tax rate applies whether or not there is life insurance company taxable income, taxable investment income, or a gain or loss from operations for the taxable year. For taxable years beginning after December 31, 1958, and before January 1, 1962, only the excess (if any) of net short-term capital gain (as defined in section 1222(5)) over net long-term capital loss (as defined in section 1222(8)) shall be taken into account in computing taxable investment income and gain or loss from operations. See sections 804(b) and 809(b). Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses (such as the rules for determining the amount, characterization, and treatment thereof) shall apply with respect to life insurance companies.

(2) *Alternative tax in case of capital gains for taxable years beginning after December 31, 1961.* For taxable years beginning after December 31, 1961, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) imposes an alternative tax in lieu of the tax imposed by section 802(a)(1), if and only if such alternative tax is less than the tax imposed by section 802(a)(1). The alternative tax is the sum of:

(i) A partial tax, computed as provided by section 802(a)(1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of the excess of its net long-term capital gain over its net short-term capital loss, and

(ii)*(a)* In the case of a taxable year beginning before January 1, 1970, an amount equal to 25 percent of such excess, or

(b) In the case of a taxable year beginning after December 31, 1969, an amount determined as provided in section 1201(a) and paragraph (a)(3) of §1.1201–1 on such excess.

In the computation of the partial tax, the deductions provided by sections 170 (as modified by section 809(a)(3)), 243, 244, 245 (as modified by sections 804 (a)(5) and 809(d)(8)(B)), and the limitation provided by section 809(f), shall not be recomputed as a result of the reduction of taxable investment income, and gain from operations, by the amount of such excess. Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses (such as the rules for determining the amount, characterization and treatment thereof) shall apply with respect to life insurance companies.

(g) *Foreign life insurance companies.* Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

(h) *Assessment and collection of tax imposed.* All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of sections 801 to 820, inclusive, are applicable to the assessment and collection of the tax imposed by section 802(a), and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(i) *Illustration of principles.* The provisions of section 802(a), other than paragraph (3) thereof, and this section may be illustrated by the following example:

Example. For the taxable year 1959, T, a life insurance company, has life insurance company taxable income of $300,000 (including $25,000 of net short-term capital gain) and $80,000 of net long-term capital gain. The tax of T under section 802(a) for 1959 is $170,500 ($90,000 normal tax, $60,500 surtax, and $20,000 capital gains tax) computed as follows:

COMPUTATION OF NORMAL TAX	
Life insurance company taxable income	$300,000
Normal tax (30% of $300,000)	90,000
COMPUTATION OF SURTAX	
Life insurance company taxable income	$300,000
Less: Exemption from surtax	25,000
Excess of life insurance company taxable income subject to surtax	275,000
Surtax (22% of $275,000)	60,500
COMPUTATION OF CAPITAL GAINS TAX	
Excess of net long-term capital gain over net short-term capital loss	$80,000
Capital gains tax (25% of $80,000)	20,000

(j) *Cross reference.* In the case of a taxable year of a life insurance company ending after December 31, 1963, for which an election under section 1562(a)(1) by a controlled group of corporations is effective, the additional tax imposed by section 1562 may apply. See section 1562 and the regulations thereunder.

[T.D. 6513, 25 FR 12658, Dec. 10, 1960, as amended by T.D. 6845, 30 FR 9740, Aug. 5, 1965; T.D. 6886, 31 FR 8685, June 23, 1966; T.D. 7337, 39 FR 44972, Dec. 30, 1974]

§ 1.802–4 Life insurance company taxable income.

(a) *Life insurance company taxable income defined.* Section 802(b) defines the term *life insurance company taxable income*, for purposes of part I, subchapter L, chapter 1 of the Code, as the sum of:

(1) The taxable investment income (as defined in section 804), or, if smaller, the gain from operations (as defined in section 809),

(2) If the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) The amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

If for any taxable year there is a loss from operations (as defined in section 809(b)(2)), the amount taken into account under paragraphs (1) and (2) of section 802(b) and subparagraphs (1) and (2) of this paragraph shall be zero. However, even in such a case, there may still be an amount includible in life insurance company taxable income (and hence an amount subject to tax) by reason of an amount includible under section 802(b)(3) and subparagraph (3) of this paragraph.

(b) *Illustration of principles.* The provisions of section 802(b) and this section may be illustrated by the following examples:

Example 1. For the taxable year 1959, Y, a life insurance company, has taxable investment income of $250,000, and a gain from operations of $175,000. Y made no subtractions from the policyholders surplus account during such taxable year. For the taxable year 1959, Y has life insurance company taxable income of $175,000.

Example 2. The facts are the same as in example 1 except that for the taxable year 1959, Y has a gain from operations of $400,000. For the taxable year 1959, Y has life insurance company taxable income of $325,000, computed by adding taxable investment income ($250,000) and 50 percent ($75,000) of the amount ($150,000) by which the gain from operations ($400,000) exceeds the taxable investment income ($250,000).

Example 3. For the taxable year 1959, W, a life insurance company, has taxable investment income of zero (0) and a gain from operations of $90,000. W made no subtractions from the policyholders surplus account during such taxable year. For the taxable year 1959, W has life insurance company taxable income of $45,000, computed by adding taxable investment income (0) and 50 percent ($45,000) of the amount ($90,000) by which the gain from operations ($90,000) exceeds the taxable investment income (0).

Example 4. For the taxable year 1961, Z, a life insurance company, has taxable investment income of $100,000, a policyholders surplus account of $50,000 as of the beginning of such taxable year, a loss from operations (as defined in section 809(b)(2)) of $25,000, and subtractions from the policyholders surplus account in the amount of $20,000. For the taxable year 1961, Z has life insurance company taxable income of $20,000, as only the amount ($20,000) subtracted from the policyholders surplus account is taken into account.

[T.D. 6513, 25 FR 12658, Dec. 10, 1960]

§ 1.802–5 Special rule for 1959 and 1960.

(a) *Transitional rule.* Section 802(a)(3) provides a transitional rule for the determination of the tax liability of a life insurance company for the taxable years 1959 and 1960 by reason of the operation of section 802(b)(3). Except as limited by section 802(a)(3) and paragraph (b) of this section, any increase in a life insurance company's tax that is attributable to the operation of section 802(b)(3) is taken into account only to the extent of one-third and two-thirds for the taxable years 1959 and 1960, respectively. To the extent there is an increase in a life insurance company's tax that is attributable to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the transitional rule provided by section 802(a)(3) and this paragraph, such amounts shall be included in ''other accounts'' under section 815(a)(3). For taxable years commencing after December 31, 1960, the full amount of any increase in tax due to the operation of section 802(b)(3) shall be imposed without any further transitional reduction.

(b) *Limitations.* The transitional rule provided by section 802(a)(3) is limited solely to an increase in tax under section 802(b)(3) that is occasioned by the operation of section 815(c)(3) (relating to subtractions from the policyholders surplus account by reason of distributions to shareholders). This rule is further limited to actual distributions that are made by life insurance companies in 1959 or 1960 and does not extend to other distributions that are treated under section 815(d)(2)(B) as made by life insurance companies in 1959 or 1960. Furthermore, section 802(a)(3) shall not apply to any increase in tax under section 802(b)(3) that is attributable to other subtractions from the policyholders surplus account by reason of the operation of the special rules contained in section 815(d). However, the transitional rule provided by section 802(a)(3) does apply in the case of a distribution to which section 815(e)(1)(B)(ii) applies.

(c) *Illustration of principles.* The provisions of section 802(a)(3) and this section may be illustrated by the following example:

Example. For the taxable year 1960, X, a life insurance company, had taxable investment income of $9,000, gain from operations of $27,000, and subtractions from the policyholders surplus account of $22,000. Based upon these figures, X had life insurance company taxable income of $40,000 for 1960, of which $18,000 was includible under section 802(b) (1) and (2) and $22,000 under section 802(b)(3). Applying the tax imposed by section 802(a)(1) (at rates as in effect for 1960), without regard to the transitional rule of section 802(a)(3), X would have a tax liability of $15,300 ($40,000 multiplied by 52 percent, less $5,500). However, applying the transitional rule of section 802(a)(3), the actual tax liability of X, for 1960, would be $12,000, computed as follows:

(1) Total tax liability (without regard to sec. 802(a)(3))		$15,300
(2) Life insurance company taxable income	$40,000	
(3) Amount subtracted from policyholders surplus account	22,000	
(4) Item (2) less item (3)	18,000	
(5) Tax on amount includible under sec. 802(b) (1) and (2) (30% of $18,000)		5,400
(6) Tax attributable to sec. 802(b)(3) (item (1) less item (5))		9,900
(7) Less: 33 1/3 percent of tax attributable to sec. 802(b)(3) (1/3 of $9,900)		3,300
(8) Tax liability for 1960 after application of sec. 802(a)(3) (item (1) less item (7))		12,000

[T.D. 6513, 25 FR 12659, Dec. 10, 1960]

§ 1.803–1 Life insurance reserves.

(a) The term ''life insurance reserves'' is defined in section 803(b). Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums held to cover the risk for the unexpired period covered by the premiums are not included in life insurance reserves. Unpaid loss reserves for noncancellable health and accident policies are included in life insurance reserves if they are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest.

(b) In the case of an assessment life insurance company or association, life insurance reserves include sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation or association of such company or association, or bylaws (approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(c) Life insurance reserves, except as otherwise provided in section 803(b), must be required by law either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute but such requirement, without more, is not conclusive; for example, life insurance reserves do not include reserves required to be maintained to provide for the ordinary running expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage; nor do they include the net value of risks reinsured in other solvent companies; liability for premiums paid in advance; liability for annual and deferred dividends declared or apportioned; liability for dividends left on deposit at interest; liability for accrued but unsettled policy claims whether known or unreported; liability for supplementary contracts not involving, at the time with respect to which the liability is computed, life, health, or accident contingencies.

(d) In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. Only reserves which are required by law or insurance department ruling, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will, except as otherwise specifically provided in section 803(b), be considered as life insurance reserves. A company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

(e) In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized mortality or morbidity tables covering disability benefits of the kind contained in policies issued by this particular class of companies but they need not be required by law.

§ 1.803–2 Adjusted reserves.

For the purpose of determining ''required interest'' for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by 7 percent. The reserves to be thus adjusted are reserves computed on preliminary term methods, such as the Illinois Standard, or the Select and Ultimate methods. Only reserves on policies in the modification period are to be so adjusted. Where reserves under a preliminary term method are the same as on the level premium method, and in the case of reserves for extended or paid-up insurance, no adjustment is to be made. The reserves are thus adjusted, and the rate of interest on which they are computed, should be reported in Schedule A, Form 1120L.

§ 1.803–3 Interest paid or accrued.

Interest paid or accrued is one of the elements to be used in computing the amount of ''required interest'' for purposes of determining the reserve interest credit provided in section 805. See

§ 1.805–1. Interest paid or accrued consists of (a) interest paid or accrued on indebtedness (except indebtedness incurred or continued to purchase or carry tax-exempt securities as set forth in section 803(f)(1)) and (b) amounts in the nature of interest paid or accrued on certain contracts, as provided in section 803(f)(2). Interest on indebtedness includes interest on dividends held on deposit and surrendered during the taxable year but does not include interest paid or accrued on deferred dividends. Life insurance reserves as defined in § 1.803–1 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which, at the time of payment, do not involve life, health, or accident contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. No distinction is made based on the person choosing the method of payment, and the full amount of the interest paid or accrued and not merely the guaranteed interest is considered as interest paid or accrued.

§ 1.803–4 Taxable income and deductions.

(a) *In general.* The taxable income of a life insurance company is its gross amount of income received or accrued during the taxable year from interest, dividends, and rents, less the deductions provided in section 803(g) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, and the special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a life insurance company provided in section 803(h), the limitations on the adjustment for amortization of premium and accrual of discount provided in section 803(i), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 803(g)(2), life insurance companies are subject to the limitations on deductions relating to wholly tax-exempt income provided in section 265. Life insurance companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross income of a life insurance company by section 803(a)(2) is allowed as a deduction from gross income by section 803(g)(1).

(c) *Investment expenses.* (1) As used in the Code, the term *general expenses* means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. Any assignment of such expense to the investment department of the company for which a deduction is claimed under section 803(g)(2) subjects the entire deduction for investment expenses to the limitation provided in that section. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes.

(2) If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses paid or incurred during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

(3) Invested assets for the purpose of section 803(g)(2) and this section are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2). They do not include real estate owned and occupied, and to the extent owned and occupied, by the company. If general expenses are assigned to or included in investment expenses,

the maximum allowance will not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses.

(d) *Taxes and expenses with respect to real estate.* The deduction for taxes and expenses under section 803(g)(3) includes taxes and expenses paid or accrued during the taxable year exclusively upon or with respect to real estate owned by the company and any sum representing taxes imposed upon a shareholder of the company upon his interest as shareholder which is paid or accrued by the company without reimbursement from the shareholder. No deduction shall be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. See paragraph (c) of this section. As to real estate owned and occupied by the company, see § 1.803–5.

(e) *Depreciation.* The deduction allowed for depreciation is, except as provided in section 803(h), identical with that allowed other corporations by section 167. The amount allowed by section 167 in the case of life insurance companies is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2).

§ 1.803–5 Real estate owned and occupied.

The amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a life insurance company is limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

§ 1.803–6 Amortization of premium and accrual of discount.

(a) Section 803(i) provides for certain adjustments on account of amortization of premium and accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases, and for accrual of discount increases, (1) the gross income, (2) the deduction for wholly tax-exempt interest, and (3) the deduction for partially tax-exempt interest.

(b) The premium for any such security is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, then its fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest call date specified therein as a day certain, the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(c) The adjustments for amortization of premium and accrual of discount will be determined:

(1) According to the method regularly employed by the company, if such method is reasonable, or

(2) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed ''regularly employed'' by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(d) The method of amortization and accrual prescribed by this section is as follows:

(1) The premium (or discount) shall be determined in accordance with this section; and

(2) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For the purpose of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

§ 1.803–7 Taxable years affected.

Sections 1.803–1 through 1.803–6 are applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments.

[T.D. 6513, 25 FR 12660, Dec. 10, 1960]

INVESTMENT INCOME

§ 1.804–3 Gross investment income of a life insurance company.

(a) *Gross investment income defined.* For purposes of part I, subchapter L, chapter 1 of the Code, section 804(b) defines the term *gross investment income* of a life insurance company as the sum of the following:

(1) The gross amount of income from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 818(b) and the regulations thereunder.

(ii) Dividends, as described in § 1.61–9.

(iii) Rents and royalties, as described in § 1.61–8.

(iv) The entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company may derive interest, rents, or royalties.

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph.

For example, gross investment income includes amounts received as commitment fees, as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage.

(2) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain (as defined in section 1222(5)) exceeds the net long-term capital loss (as defined in section 1222(8)), and

(3) The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner.

(b) *No double inclusion of income.* In computing the gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner, any item described in section 804(b)(1) and paragraph (a)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business or partnership, but shall be taken into account under section 804(b)(1) and paragraph (a)(1) of this section.

(c) *Exclusion of net long-term capital gains.* Any net long-term capital gains from the sale or exchange of a capital asset (or any gain considered to be from the sale or exchange of a capital asset under applicable law) shall be excluded from the gross investment income of a life insurance company. However, section 804(b)(2) and paragraph (a)(2) of this section provide that the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss shall be included in the gross investment income of a life insurance company.

[T.D. 6513, 25 FR 12661, Dec. 10, 1960]

§ 1.804–4 Investment yield of a life insurance company.

(a) *Investment yield defined.* Section 804(c) defines the term ''investment yield'' of a life insurance company for purposes of part I, subchapter L, chapter 1 of the Code. Investment yield means gross investment income (as defined in section 804(b) and paragraph (a) of § 1.804–3), less the deductions provided in section 804(c) and paragraph (b) of this section for investment expenses, real estate expenses, depreciation, depletion, and trade or business (other than an insurance business) expenses. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code. For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162, and under section 265, no deduction is allowable for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under chapter 1 of the Code. A deduction shall not be permitted with respect to the same item more than once.

(b) *Deductions from gross investment income*—(1) *Investment expenses.* (i) Section 804(c)(1) provides for the deduction of investment expenses by a life insurance company in determining investment yield. ''Investment expenses'' are those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a life insurance company for which a deduction is claimed under section 804(c)(1) subjects the entire deduction for investment expenses to the limitation provided in that section and subdivision (iii) of this subparagraph. As used in section 804(c)(1), the term *general expenses* means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if real estate taxes, depreciation, or other expenses attributable to office space owned by the company and utilized by it in connection with its investment function are assigned to investment expenses, such items shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. Similarly, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expenses are allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 804(c)(1)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any. In cases where the investment expenses allowable as deductions under section 804(c)(1) exceed the limitation contained therein, see section 809(d)(9).

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 804(c)(1) shall not exceed the sum of:

(a) One-fourth of one percent of the mean of the assets (as defined in section 805(b)(4) and paragraph (a)(4) of §1.805–5) held at the beginning and end of the taxable year,

(b) The amount of the mortgage service fees for the taxable year, plus

(c) Whichever of the following is the greater:

(1) One-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by section 804(c)(1)) exceeds 3 3/4 percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year, reduced by the amount of the mortgage service fees for the taxable year, or

(2) One-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year. For purposes of the preceding sentence, the term *mortgages held* refers to mortgages, and other similar liens, on real property which are held by the company as security for ''mortgage loans''.

For purposes of section 804(c)(1)(B) and (C)(i) and (*b*) and (*c*)(*1*) of this subdivision, the term *mortgage service fees* includes mortgage origination fees. Such mortgage origination fees shall be amortized in accordance with the rules prescribed in section 818(b) and the regulations thereunder.

(iv) The operation of the limitation contained in section 804(c)(1) and subdivision (iii) of this subparagraph may be illustrated by the following example:

Example. The books of S, a life insurance company, reflect the following items for the taxable year 1958:

Investment expenses (including general expenses assigned to or included in investment expenses)	$125,000
Mean of the assets held at the beginning and end of the taxable year	20,000,000
Mortgage service fees	25,000
Investment yield computed without regard to investment expenses	1,200,000
Mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees	6,000,000

In order to determine the limitation on investment expenses, S would make up the following schedule:

1. Mean of the assets held at the beginning and end of the taxable year	$20,000,000	
2. One-fourth of 1 percent of item 1 (1/4 of 1% of $20,000,000)	50,000	
3. Mortgage service fees	25,000	
4. The greater of (a) or (b):		
(a)(i) Investment yield computed without regard to investment expenses	$1,200,000	
(ii) Three and three-fourths percent of item 1 (3 3/4% × $20,000,000)	750,000	
(iii) Excess of (i) over (ii) ($1,200,000 minus $750,000)	450,000	
(iv) One-fourth of (iii) (1/4 × $450,000)	112,500	
(v) Less: Mortgage service fees (item 3)	25,00	
(vi) Excess of (iv) over (v) ($112,500 minus $25,000)	87,500	
(b) One-fourth of 1 percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees (1/4 of 1% × $6,000,000)	15,000	
5. The greater of item 4 (a) or (b)		87,500
6. Limitation on investment expenses (items 2, 3, and 4(a))		162,500

As the investment expenses (including general expenses assigned to or included in investment expenses) of S for the taxable year 1958 ($125,000) do not exceed the limitation on such expenses ($162,500), S would be entitled to deduct the entire $125,000 under section 804(c)(1).

(2) *Real estate expenses and taxes.* The deduction for expenses and taxes under section 804(c)(2) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or

with respect to real estate owned by the company. For example, no deduction shall be allowed under section 804(c)(2) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 804(c)(2) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See subparagraph (4) of this paragraph for limitation of such deduction.

(3) *Depreciation.* The deduction allowed for depreciation is, except as provided in section 804(c)(3) and subparagraph (4) of this paragraph, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining investment yield is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 804(b). An election with respect to any of the methods of depreciation provided in section 167 shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112). However, in appropriate cases, the method of depreciation may be changed with the consent of the Commissioner. See section 167(e) and § 1.167(e)–1. See subparagraph (4) of this paragraph for limitation of such deduction. See section 809(d)(12) and the regulations thereunder for the treatment of depreciable property used in the operation of a life insurance business.

(4) *Limitation on deductions allowable under section 804 (c)(2) and (c)(3).* Section 804(c)(3) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, T, a life insurance company, owns a twenty-story downtown home office building. The rental value of each floor of the building is identical. T rents nine floors to various tenants, one floor is utilized by it in operating its investment department, and the remaining ten floors are occupied by it in carrying on its insurance business. Since floor space equivalent to eleven-twentieths, or 55 percent, of the rental value of the entire property is owned and occupied for insurance purposes by the company, the deductions allowable under section 804(c)(2) and (3) for taxes, depreciation, and other real estate expenses shall be limited to nine-twentieths, or 45 percent, of the taxes, depreciation, and other real estate expenses on account of the entire property. However, the portion of such allowable deductions attributable to the operation of the investment department (one-twentieth, or 5 percent) may be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitations of section 804(c)(1). Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company in carrying on its insurance business, together with the respective rental values thereof, must be shown in a schedule accompanying the return.

(5) *Depletion.* The deduction for depletion (and depreciation) provided in section 804(c)(4) is identical to that allowed other corporations by section 611. The amount allowed by section 611 in the case of a life insurance company is limited to depletion (and depreciation) sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 804(b). See section 611 and § 1.611–5 for special rules relating to the depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber.

(6) *Trade or business deductions.* (i) Under section 804(c)(5), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company,

or by a partnership of which the life insurance company is a partner are, subject to the limitations in subdivisions (ii), (iii), and (iv) of this subparagraph, allowable as deductions from the gross investment income of a life insurance company in determining its investment yield. Such deductions are allowable, however, only to the extent that they are attributable to the production of income which is included in the life insurance company's gross investment income by reason of section 804(b)(3). However, since any interest, dividends, rents, and royalties received by any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner, is included in the life insurance company's gross investment income by reason of section 804(b)(1) and paragraph (b) of § 1.804–3, any expenses fairly chargeable against the production of such income may be deductible under section 804(c) (1), (2), (3), or (4). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 804(c)(5), there shall be excluded losses:

(a) From (or considered as from) sales or exchanges of capital assets,

(b) From sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(c) From the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(iii) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if a life insurance company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(iv) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII, subchapter B, chapter 1 of the Code, shall not be allowed.

[T.D. 6513, 25 FR 12662, Dec. 10, 1960]

§ 1.806–1 Adjustment for certain reserves.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance contracts) must add to its life insurance company taxable income (as a factor in determining 1954 adjusted taxable income) an amount equal to eight times the amount of the adjustment for certain reserves provided in paragraph (b) of this section.

(b) The adjustment for certain reserves referred to in paragraph (a) of this section shall be an amount equal to 3 1/4 percent of the mean of the unearned premiums and unpaid losses at the beginning and end of the taxable year on such other contracts as are not included in life insurance reserves. If such unearned premiums, however, are less than 25 percent of the net premiums written during the taxable year on such other contracts, then the adjustment shall be 3 1/4 percent of 25 percent of the net premiums written during the taxable year on such other contracts plus 3 1/4 percent of the mean of the unpaid losses at the beginning and end of the taxable year on such other contracts. As used in this section, the term ''unearned premiums'' has the same meaning as in section 832(b)(4) and§ 1.832–1.

§ 1.806–2 Taxable years affected.

Section 1.806–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.806–3 and 1.806–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6513, 25 FR 12668, Dec. 10, 1960]

§ 1.806–3 Certain changes in reserves and assets.

(a) *In general.* For purposes of part I, subchapter L, chapter 1 of the Code, section 806(a) provides that if there is a change in life insurance reserves (as defined in section 801(b)), during the taxable year, which is attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such life insurance reserves, then the means of such reserves, and the mean of the assets, shall be appropriately adjusted to reflect the amounts involved in such transfer. For example, the adjustments required under section 806(a) are applicable to transfers in which one life insurance company purchases or acquires a part or all of the business of another life insurance company under an arrangement whereby the purchaser or transferee becomes solely liable on the contracts transferred. This provision shall apply in the case of assumption reinsurance but not in the case of indemnity reinsurance or reinsurance ceded. Thus, no adjustments shall be required under section 806(a) when, in the ordinary course of business, an indemnity reinsurance contract is entered into with another company (on a yearly renewable term basis, on a coinsurance basis, or otherwise) whereby there is a sharing of risks under one or more individual contracts. It will be necessary for each life insurance company participating in a transfer described in section 806(a) to make the adjustments required by such section. Such adjustments shall be made without regard to whether or not the transferor of the liabilities was the original insurer.

(b) *Manner in which adjustments shall be made*—(1) *Daily basis.* The means of the life insurance reserves, and the mean of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in a transfer described in section 806(a) and paragraph (a) of this section. The transferor and the transferee shall be treated as having held such life insurance reserves and assets for a fraction of the year in which the transfer occurs.

(2) *Determination of period held.* In determining the fraction which represents the fractional year that such reserves and assets were held, the numerator shall be the number of days during the taxable year which such reserves and assets were actually held, and the denominator shall be the number of days in the calendar year of the transfer. In computing the period held for purposes of the numerator, the day on which such reserves and assets are transferred is included by the transferor and excluded by the transferee.

(3) *Adjustments to the means of life insurance reserves and assets not transferred.* All life insurance reserves and assets transferred during the taxable year, within the meaning of section 806(a), shall be excluded from the beginning and end of the taxable year balances of the transferor and transferee, respectively. The amount of assets to be excluded from the beginning of the taxable year balance of the transferor shall be an amount equal to the value of such reserves at the beginning of the taxable year. The amount of assets to be excluded from the end of the taxable year balance of the transferee shall be an amount equal to the value of such reserves at the end of the taxable year. The means of the life insurance reserves and assets not so transferred shall be determined in the ordinary manner, that is, the arithmetic means. There shall be added to these means an amount to appropriately adjust them, on a daily basis, for the life insurance reserves and assets that were transferred during the taxable year. This adjustment shall be determined by multiplying (i) the mean of the transferred life insurance reserves (or assets, as the case may be) at the beginning of the taxable year (or, if acquired later, at the beginning of the period held as defined in subparagraph (2) of this paragraph) and the end of the period held as defined in subparagraph (2) of this paragraph (or at the end of the taxable year, if held

at such time) by (ii) the fraction determined under subparagraph (2) of this paragraph.

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

Example 1. On March 14, 1958, the M Company, a life insurance company, transferred to the N Company, a life insurance company, pursuant to an assumption reinsurance agreement, all of its life insurance reserves, and related assets, on one block of policies. The reserves (and assets) for this block were held by the M Company on January 1, 1958, and totaled $60,000; on March 14, the reserves (and assets) totaled $64,000. The M Company had life insurance reserves of $1,000,000 at the beginning of 1958 (including those subsequently transferred) and $1,040,000 at the end of 1958. The M Company had assets of $1,300,000 at the beginning of 1958 (including those subsequently transferred) and $1,380,000 at the end of 1958. The mean of M's life insurance reserves for the taxable year 1958 is computed as follows:

Reserves at 1–1–58	$1,000,000	
Exclude reserves (at beginning of year) on contracts transferred to N	60,000	
Recomputed amount at 1–1–58		$940,000
Reserves at 12–31–58		1,040,000
Sum		1,980,000
Mean		990,000
Adjustment for reserves transferred on 8–14–58:		
Reserves at 1–1–58 on contracts transferred to N	$60,000	
Reserves at 3–14–58 on such contracts	64,000	
Sum	124,000	
Mean	62,000	
Fraction taken into account	73/365	
Adjustment (73/365×$62,000)		$12,400
Mean of M's life insurance reserves after section 806(a) adjustment		1,002,400

Example 2. Assuming the facts to be the same as in example 1, the mean of M's assets for the taxable year 1958 is computed as follows:

Assets at 1–1–58	$1,300,000	
Exclude assets (at beginning of year) on contracts transferred to N	60,000	
Recomputed amount at 1–1–58		$1,240,000
Assets at 12–31–58		1,380,000
Sum		2,620,000
Mean		1,310,000
Adjustments for assets transferred on 3–14–58:		
Assets at 1–1–58 on contracts transferred to N	$60,000	
Assets at 3–14–58 on such contracts	64,000	
Sum	124,000	
Mean	62,000	
Fraction taken into account	73/365	
Adjustment (73/365×$62,000) –		$12,400
Mean of M's assets after section 806(a) adjustment		1,322,400

Example 3. Assume the facts are the same as in example 1. At the end of 1958, N Company had life insurance reserves (and assets) of $80,000 on the contracts transferred on March 14, 1958. The N Company had life insurance reserves of $6,000,000 at the beginning of 1958 and $6,400,000 at the end of 1958 (including those transferred). The N Company had assets of $6,800,000 at the beginning of 1958 and $7,300,000 at the end of 1958 (including those on the contracts transferred). The mean of N's life insurance reserves for the taxable year 1958 is computed as follows:

Reserves at 1–1–58		$6,000,000
Reserves at 12–31–58	$6,400,000	
Exclude reserves (at end of year) on contracts transferred from M	80,000	
Recomputed amount at 12–31–58		6,320,000
Sum		12,320,000
Mean		6,160,000
Adjustment for reserves transferred on 3–14–58:		
Reserves at 3–14–58 on contracts transferred from M	$64,000	
Reserves at 12–31–58 on such contracts	80,000	
Sum	144,000	
Mean	72,000	
Fraction taken into account	292/365	
Adjustment (292/365×$72,000)		57,600
Mean of N's life insurance reserves after section 806(a) adjustment		6,217,600

Example 4. Assuming the facts to be the same as in example 3, the mean of N's assets for the taxable year 1958 is computed as follows:

Assets at 1–1–58		$6,800,000
Assets at 12–31–58	$7,300,000	
Exclude assets (at end of year) on contracts transferred from M	80,000	
Recomputed amount at 12–31–58		7,220,000
Sum		14,020,000
Mean		7,010,000
Adjustments for assets transferred on 3–14–58:		
Assets at 3–14–58 on contracts transferred from M	$64,000	

Assets at 12–31–58 on such contracts	80,000	
Sum	144,000	
Mean	72,000	
Fraction taken into account	292/365	
Adjustment (292/365×$72,000)		$57,600
Mean of N's assets after section 806(a) adjustment		7,067,600

Example 5. The facts are the same as in example 1, except that on October 19, 1958, company N transfers to company P, a life insurance company, all of the life insurance reserves, and related assets, on the block of policies it had received from company M on March 14, 1958. The reserves (and assets) for this block totaled $76,000 on October 19, 1958. The means of company M's life insurance reserves and assets, as computed in examples 1 and (2), respectively, would be unchanged by the transfer of October 19, 1958. Since company N did not own this block of policies at either the beginning or end of the taxable year, it would not have to recompute its beginning or end of the taxable year reserves or assets. Company N will, however, have to adjust (or increase) the mean of its life insurance reserves and assets on account of the policies it received from company M. This adjustment will be $42,000, which is determined by multiplying the means of the life insurance reserves (or assets) on these policies as of March 15, 1958, and October 19, 1958, $70,000 ($64,000+$76,000=$140,000÷2) by the fraction 219/365 (the numerator of 219 is determined by excluding the day of the transfer to N, March 14, 1958, and including the day of the transfer from N to P, October 19, 1958). Company P will have to recompute its end of the year life insurance reserves and assets (in the same manner as illustrated in examples 3 and 4). Assuming the end of the year reserves (and assets) on this block of policies is $80,000, company P will have an adjustment under section 806 (a) of $15,600, which is determined by multiplying the means of the reserves on these policies as of October 20, 1958, and December 31, 1958, $78,000 ($76,000+$80,000= $156,000÷2) by the fraction 73/365.

[T.D. 6513, 25 FR 12663, Dec. 10, 1960]

§ 1.806–4 Change of basis in computing reserves.

(a) *In general.* For purposes of subpart B, part I, subchapter L, chapter 1 of the Code, section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) (relating to items taken into account) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then in determining taxable investment income the amount of the item as of the close of the taxable year shall be the amount computed on the old basis, and the amount of the item as of the beginning of the next taxable year shall be the amount computed on the new basis. For purposes of the preceding sentence, an election under section 818(c) shall not be treated as a change in basis for determining the amount of an item referred to in section 810(c). A change of basis in computing any of the items referred to in section 810(c) is not a change of accounting method requiring the consent of the Secretary or his delegate under section 446(e).

(b) *Illustration of change of basis in computing reserves.* The application of section 806(b) and paragraph (a) of this section may be illustrated by the following examples:

Example 1. Assume that the life insurance reserves of Y, a life insurance company, at the beginning of the taxable year 1959 are $100 and that during such taxable year a portion of the reserves is strengthened (by reason of a change in mortality or interest assumptions, or otherwise), so that at the end of the taxable year 1959 the reserves (computed on the new basis) are $130 but computed on the old basis would be $120. Assume further that at the close of the next taxable year, 1960, the reserves (computed on the new basis) are $142. Under the provisions of section 806(b) and paragraph (a) of this section, the mean of such reserves for the taxable year of the reserve strengthening, namely 1959, is $110 (the mean of $100, the balance at the beginning of the taxable year 1959, and $120, the balance at the end of the taxable year 1959 computed on the old basis). The mean of such reserves for the next taxable year, 1960, is $136 (the mean of $130, the balance at the beginning of the taxable year 1960 computed on the new basis, and $142, the balance at the end of the taxable year 1960 computed on the new basis).

Example 2. The life insurance reserves of S, a life insurance company, computed with respect to contracts for which such reserves are determined on a recognized preliminary term basis amount to $50 on January 1, 1959, and $80 on December 31, 1959. For the taxable year 1959, S elects to revalue such reserves on a net level premium basis under section 818(c). Such reserves computed under section 818(c) amount to $60 on January 1, 1959, and $96 on December 31, 1959. Under the provisions of paragraph (a) of this section, the mean of such reserves for the taxable year 1959 is $78 (the mean of $60, the balance at the beginning of the taxable year 1959 computed under section 818(c), and $96, the balance at the end of the taxable year 1959 computed under section 818(c).

[T.D. 6513, 25 FR 12669, Dec. 10, 1960]

§ 1.807–1 Mortality and morbidity tables.

(a) *Tables to be used.* If there are no commissioners' standard tables applicable to an insurance contract when the contract is issued, then the mortality and morbidity tables set forth in this subsection are used to compute reserves under section 807(d)(2) for the contract.

Type of Contract	Table
1. Group term life insurance (active life reserves).	1960 Commissioners' Standard Group Mortality Table.
2. Group life insurance (active life reserves); accidental death benefits.	1959 Accidental Death Benefits Table.
3. Permanent and paid-up group life insurance (active life reserves).	Same table as are applicable to males for ordinary life insurance.
4a. Group life insurance disability income benefits (active life reserves).	The tables of period 2 disablement rates and the 1930 to 1950 termination rates of the 1952 Disability Study of the Society of Actuaries.
4b. Group life insurance disability income benefits (disabled life reserves).	The 1930 to 1950 termination rates of the 1952 Disability study of the Society of Actuaries.
5. Group life insurance; survivor income benefits insurance.	Same tables as are applicable to group annuities.
6. Group life insurance; extended death benefits for disabled lives.	1970 Intercompany Group life Disability Valuation Table.
7. Credit life insurance	1958 Commissions' Extended Term Table.
8. Supplementary contracts involving life contingencies.	Same tables as are applicable to individual immediate annuities.
9. Noncancellable accident and health insurance (active life reserves); benefits issued before 1984.	Tables used for NAIC annual statement reserves as of December 31, 1983.
10a. Noncancellable accident and health insurance (active life reserves); group disability benefits issued after 1983 and individual disability benefits issued after 1983 and before 1989.	1964 Commissioners' Disability Tables.
10b. Noncancellable accident and health insurance (active life reserves); individual disability benefits issued after 1988.	1985 Commissioners' Individual Disability Table A or Commissioners' Individual Disability Table B.
11. Noncancellable accident and health insurance (active life reserves); accidental death benefits issued after 1983.	1959 Accidental Death Benefits Tables.
12. Noncancellable accident and health insurance (active life reserves); all benefits issued after 1983 other than disability and accidental death.	Tables used for NAIC annual statement reserves.
13a. Noncancellable accident and health insurance (claim reserves); group disability benefits for all years of issue and individual disability benefits for years before 1989.	1964 Commissioners' Disability Tables.
13b. Noncancellable accident and health insurance (claim reserves); individual disability benefits for years after 1988.	1985 Commissioners' Individual Disability Table A or Commissioners' Individual Disability Table B.
14. Noncancellable accident and health insurance (claim reserves); all benefits other than disability for all years of issue.	Tables used for annual statement reserves.

(b) *Adjustments.* An appropriate adjustment may be made to the tables in paragraph (a) of this section to reflect risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

(c) *Special rule where more than 1 table or option applicable.* If, with respect to any category of risks, there are 2 or more tables (or options under 1 or more tables) in paragraph (a) of this section, the table (and option thereunder) which generally yields the lowest reserves shall be used to compute reserves under section 807(d)(2) for the contract.

(d) *Effective date.* This section is effective for taxable years beginning after December 31, 1983, except that the 1985 Commissioners' Individual Disability Tables A and B shall be treated (for purposes of section 807(d)(5)(B) and for purposes of determining the issue dates of contracts for which they shall be used) as if the tables were new prevailing commissioners' standard tables adopted by the twenty-sixth State on December 26, 1989.

[T.D. 8278, 54 FR 52934, Dec. 26, 1989; 55 FR 1768, Jan. 18, 1990]

§ 1.807–2 Cross-reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and § 1.817A–1(a)(1)), *see* § 1.817A–1.

[T.D. 9058, 68 FR 24350, May 7, 2003]

GAIN AND LOSS FROM OPERATIONS

§ 1.809–1 Taxable years affected.

Sections 1.809 through 1.809–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all reference to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), the Act of June 27, 1961 (75 Stat. 120), the Act of October 10, 1962 (76 Stat. 808); the Act of October 23, 1962 (76 Stat. 1134), and section 214(b)(4) of the Revenue Act of 1964 (78 Stat. 55).

[T.D. 6992, 34 FR 827, Jan. 18, 1969]

§ 1.809–2 Exclusion of share of investment yield set aside for policyholders.

(a) *In general.* Section 809 provides the rules for determining the gain or loss from operations of a life insurance company, which amount is necessary to determine life insurance company taxable income. In order to determine gain or loss from operations, a life insurance company must first determine the share of each and every item of its investment yield (as defined in section 804(c) and paragraph (a) of § 1.804–4) set aside for policyholders (as computed under section 809(a)(1) and paragraph (b) of this section), as this share is excluded from gain or loss from operations (as defined in section 809(b) (1) and (2) and paragraphs (a) and (b) of § 1.809–3, respectively). The life insurance company shall then add its share of each and every item of its investment yield to the sum of the items comprising gross amount (as described in section 809(c) and paragraph (a) of § 1.809–4). In addition, the life insurance company shall, for taxable years beginning after December 31, 1961, add the amount (if any) by which its net long-term capital gain exceeds its net short-term loss. From the sum so computed (which includes the capital gains item only for taxable years beginning after December 31, 1961) there shall then be subtracted the deductions provided in section 809(d) and paragraph (a) of § 1.809–5. The amount thus obtained is the gain or loss from operations for the taxable year.

(b) *Computation of share of investment yield set aside for policyholders.* Section 809(a)(1) provides that the share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For this purpose, the percentage used in determining the share of each of these items comprising the investment yield set aside for policyholders shall be determined by dividing the required interest (as defined in section 809(a)(2) and paragraph (d) of this section) by the investment yield (as defined in section 804(c) and paragraph (a) of § 1.804–4). The percentage thus obtained is then applied to each and every item of the investment yield so that the share of each and every item of investment yield set aside for policyholders shall be excluded from gain or loss from operations. However, if in any case the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(c) *Computation of life insurance company's share of investment yield.* For purposes of subpart C, part I, subchapter L, chapter 1 of the Code, section 809(b)(3) provides that the percentage used in determining the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be obtained by subtracting the percentage obtained under paragraph (b) of this section from 100 percent. For example, if the policyholders' percentage (as determined under section 809(a)(1) and paragraph (b) of this section) is 72.38 percent, then the life insurance company's share is 27.62 percent (100 percent minus 72.38 percent). In such a case, if the amount of a particular item is $200, then the life insurance company's share of such item included in determining gain or loss from operations is $55.24 ($200 multiplied by 27.62 percent) and the share of such item set aside for policyholders (which is excluded from gain or loss from operations) is $144.76 ($200 multiplied by 72.38 percent). For purposes of determining gain or loss from operations, the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be added to the sum of the items comprising gross amount (as described in section 809(c) and paragraph (a) of § 1.809–4).

(d) *Required interest defined.* (1) For purposes of part I, section 809(a)(2) defines the term *required interest* for any taxable year as the sum of the products obtained by multiplying (i) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by (ii) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year. In the case of the reserves described in section 810(c)(1), such rate of interest shall be the same as that used by the taxpayer for purposes of paragraph (b) of § 1.801–5 (relating to the definition of reserves required by law) with respect to such reserves. In the case of the reserves described in section 810(c)(2) through (5), such rate of interest shall be the same as that actually paid, credited, or accrued by the taxpayer with respect to such reserves. Thus, the required interest for any taxable year includes the elements of interest paid (as defined in section 805(e)) with respect to the reserves described in section 810(c).

(2) For purposes of computing required interest under section 809(a)(2) and subparagraph (1) of this paragraph, the amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets) before applying the rate of interest required, or assumed by the taxpayer, thereto. However, in the case of the adjustments required by section 810(d) as a result of a change in the basis of computing reserves, the adjustments to any of the reserves described in section 810(c) shall be taken into account in accordance with the rules prescribed in section 810(d) and § 1.810–3.

[T.D. 6535, 26 FR 525, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8687, June 23, 1966]

§ 1.809–3 Gain and loss from operations defined.

(a) *Gain from operations.* For purposes of part I, subchapter L, chapter 1 of the Code, section 809(b)(1) defines the term *gain from operations* as the excess of the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of § 1.809–4, and (3) for taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, over the sum of the deductions provided by section 809(d) and § 1.809–5.

(b) *Loss from operations.* For purposes of part I, section 809(b)(2) defines the term *loss from operations* as the excess of the sum of the deductions provided by section 809(d) and § 1.809–5 over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of § 1.809–4, and (3) for taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss.

(c) *Illustration of principles.* The provisions of section 809(b) (1) through (3) and paragraphs (a) and (b) of this section may be illustrated by the following example:

Example. For the taxable year 1958, T, a life insurance company, had investment yield of $900,000, including $150,000 of dividends received from domestic corporations subject to taxation under chapter 1 of the Code, $10,000 of wholly tax-exempt interest, and $78,000 of partially tax-exempt interest. T also had items of gross amount under section 809(c) in the amount of $12,000,000 and deductions under section 809(d) of $6,963,500 (exclusive of any deductions for wholly tax-exempt interest, partially tax-exempt interest, and dividends received). For such taxable year, the share of each and every item of investment yield set aside for policyholders was 80 percent and the company's share of each and every item of investment yield was 20 percent. Based upon these figures, T had a gain from operations of $5,180,000 for the taxable year 1958, computed as follows:

	Col. 1	Col. 2 (80%×Col. 1) exclusion of policyholder's share	Col. 3 (20%×Col. 1) company's share
Interest wholly tax-exempt	$10,000	$8,000	$2,000
Interest partially tax-exempt	78,000	62,400	15,600
Dividends received	50,000	120,000	30,000
Other items of investment yield	662,000	529,600	132,400
Investment yield	900,000	720,000	180,000
Gross amount (sum of items under sec. 809(c))			$12,000,000
Total			12,180,000
Less:			
Deductions under sec. 809(d)(8):			
Company's share of interest wholly tax-exempt		$2,000	
30/52 of company's share of interest partially tax-exempt (30/52 ×$15,600)		9,000	
85% of company's share of dividends received (but not to exceed 85% of gain from operations as computed under sec. 809(d)(8)(B)) (85%×$30,000)		25,500	
All other deductions under sec. 809(d)		6,963,500	
			7,000,000
Gain from operations			5,180,000

(d) *Exception.* (1) In accordance with section 809(b)(4), if it is established in any case to the satisfaction of the Commissioner, or by a determination of The Tax Court of the United States, or of any other court of competent jurisdiction, which has become final, that the application of the definition of gain from operations contained in section 809(b)(1) results in the imposition of tax on:

(i) Any interest which under section 103 is excluded from gross income,

(ii) Any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(iii) Any amount of dividends received which under sections 243, 244, and 245 (as modified by section 809(d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(2) For the date upon which a decision by the Tax Court becomes final, see section 7481. For the date upon which a judgment of any other court becomes final, see paragraph (c) of § 1.1313(a)–1.

[T.D. 6535, 26 FR 526, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8687, June 28, 1966]

§ 1.809–4 Gross amount.

(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b) (1) and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809(a)(1) and paragraph (c) of § 1.809–2), and the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (such capital gains item is included in determining gain or loss from operations only for taxable years beginning after December 31, 1961). The additional three categories of items taken into account are:

(1) *Premiums.* (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term *gross amount of all premiums* means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required

to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of §1.809–5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)).

(ii) The term *return premiums* means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c)(1) and this subparagraph, the term *reinsurance ceded* means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a)(7)(ii) of §1.809–5 for the definition of assumption reinsurance.

(2) *Decreases in certain reserves.* Each net decrease in reserves which is required by section 810 (a) and (d)(1) or 811(b)(2) to be taken into account for the taxable year as a net decrease for purposes of section 809(c)(2).

(3) *Other amounts.* All amounts, not included in computing investment yield and not otherwise taken into account under section 809(c) (1) or (2), shall be taken into account under section 809(c)(3) to the extent that such amounts are includible in gross income under subtitle A of the Code. See section 61 (relating to gross income defined) and the regulations thereunder.

(b) *Treatment of net long-term capital gains.* For taxable years beginning before January 1, 1962, any net long-term capital gains (as defined in section 1222(7)) from the sale or exchange of a capital asset (or any gain considered to be from the sale or exchange of a capital asset under applicable law) shall be excluded from the determination of gain or loss from operations of a life insurance company. On the other hand, with respect to taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (as defined in section 1222(6)) shall be taken into account in determining gain or loss from operations under section 809. However, for any taxable year beginning after December 31, 1958, the excess of net short-term capital gain (as defined in section 1222(5)) over net long-term capital loss (as defined in section 1222(8)) is included in computing investment yield (as defined in section 804(c)) and, to that extent, is taken into account in determining gain or loss from operations under section 809.

[T.D. 6535, 26 FR 527, Jan. 20, 1961, as amended by T.D. 6610, 27 FR 8718, Aug. 31, 1962, T.D. 6886, 31 FR 8687, June 23, 1966]

§ 1.809–5 Deductions.

(a) *Deductions allowed.* Section 809(d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b) (1) and (2), respectively:

(1) *Death benefits, etc.* All claims and benefits accrued (less reinsurance recoverable), and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto). The term *all claims and benefits accrued* includes, for example, matured endowments and amounts allowed on surrender. The term *losses incurred (whether or not ascertained)* includes a reasonable estimate of the amount of the losses (based

upon the facts in each case and the company's experience with similar cases) incurred but not reported by the end of the taxable year as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year.

(2) *Increases in certain reserves.* The net increase in reserves which is required by section 810 (b) and (d)(1) to be taken into account for the taxable year as a net increase for purposes of section 809(d)(2).

(3) *Dividends to policyholders.* The deduction for dividends to policyholders as determined under section 811(b) and § 1.811–2. Except as provided in section 809(d)(3) and this subparagraph, no amount shall be allowed as a deduction in respect of dividends to policyholders under section 809(d). See section 809(f) and § 1.809–7 for limitation of such deduction.

(4) *Operations loss deduction.* The operations loss deduction as determined under section 812.

(5) *Certain nonparticipating contracts.* (i) An amount equal to the greater of:

(a) 10 percent of the increase for the taxable year in certain life insurance reserves for nonparticipating contracts (other than group contracts); or

(b) 3 percent of the premiums for the taxable year attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more.

(ii) For purposes of section 809(d)(5) and this subparagraph, the term *nonparticipating contracts* means those contracts which during the taxable year contain no right to participate in the divisible surplus of the company. For example, if at any time during the taxable year for which the deduction allowed under section 809(d)(5) and this subparagraph is claimed such contracts have rights to dividends or similar distributions (as defined in section 811(a) and paragraph (a) of § 1.811–2), such contracts shall no longer be deemed nonparticipating contracts and, therefore, no deduction shall be allowed. Thus, if a class of contracts having no right to participate in the divisible surplus of the company is in force for nine years and on March 10, 1958, it is announced that such contracts shall be accorded dividend rights as of August 1, 1958, no deduction shall be allowed under section 809(d)(5) and this subparagraph for the taxable year 1958 or any succeeding taxable year, whether or not dividends are actually paid on such contracts. However, if the announcement of March 10, 1958, states that such contracts shall be accorded dividend rights as of January 1, 1959, a deduction under section 809(d)(5) and this subparagraph shall be allowed for the taxable year 1958 but not for any succeeding taxable year.

(iii) For purposes of section 809(d)(5) and this subparagraph, the term *reserves for nonparticipating contracts* means such part of the life insurance reserves (as defined in section 801(b) and § 1.801–4), other than that portion of such reserves which is allocable to annuity features, as relates to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph). The amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets). In the case of the adjustments required by section 810(d) (relating to adjustment for change in computing reserves), the increase in life insurance reserves attributable to reserve strengthening shall be taken into account in accordance with the rules prescribed in section 810(d) and § 1.810–3.

(iv) For purposes of section 809(d)(5) and this subparagraph, the term *premiums* means the net amount of the premiums and other consideration attributable to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph) which are taken into account under section 809(c)(1). For this purpose, premiums include only such amounts attributable to such contracts which are issued or renewed for periods of 5 years or more, but does not include that portion of the premiums which is allocable to annuity features. No portion of a premium shall be deemed allocable to annuity features solely because a contract, such as an endowment contract, provides that at maturity the insured shall have an option to take an annuity. The determination of whether a contract meets the 5-year requirement shall be made as of the date the contract is issued, or as of the date it is renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy shall qualify for the deduction under section 809(d)(5), even though the insured subsequently dies at the end of the second year, since the policy is issued for a period of 5 years or more. However, a 1-year renewable term contract shall not qualify, since as of the date it is issued (or of any renewal date) it is not issued (or renewed) for a period of 5 years or more. In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period shall not qualify. However, if this policy is renewed for a period of 5 years or more, the policy shall qualify for the deduction under section 809(d)(5) from the date it is renewed.

(v) The provisions of section 809(d)(5) and this subparagraph may be illustrated by the following example:

Example. Assume the following facts with respect to X, a life insurance company, for the taxable year 1958:

Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1–1–58	$150,000
Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12–31–58	225,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 1–1–58	48,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 12–31–58	57,000
Premiums on nonparticipating contracts without annuity features (other than group contracts) issued or renewed for 5 years or more	85,000
Premiums on nonparticipating contracts allocable to annuity features (other than group contracts) issued or renewed for 5 years or more	14,000
Return premiums on nonparticipating contracts without annuity features (other than group contracts)	5,000

In order to determine the deduction under section 809(d)(5) (without regard to the limitation of section 809(f)), X would make up the following schedule:

(1) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12–31–58	$225,000	
(2) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1–1–58	150,000	
(3) Excess of item (1) over item (2) ($225,000 minus $150,000)	75,000	
(4) 10 percent of item (3) (10%×$75,000)		7,500
(5) Net premiums on nonparticipating contracts without annuity features issued or renewed for 5 years or more (other than group contracts) (gross premiums on such contracts ($85,000) minus return premiums ($5,000) on such contracts)	80,000	
(6) 3 percent of item (5) (3%×$80,000)		2,400
(7) The greater of item (4) or item (6)		7,500
(8) Tentative deduction under sec. 809(d)(5) (computed without regard to the limitation of sec. 809(f))		7,500

(vi) See section 809(f) and §1.809–7 for limitation of the deduction provided by this subparagraph.

(6) *Certain accident and health insurance and group life insurance.* (i) For taxable years beginning before January 1, 1963, an amount equal to two percent of the premiums for the taxable year attributable to group life insurance contracts, group accident and health insurance contracts, or group accident and health insurance contracts with a life feature. For taxable years beginning after December 31, 1962, the deduction shall be an amount equal to two percent of the premiums for the taxable year attributable to group life insurance contracts, accident and health insurance contracts (other than those to which section 809(d)(5) applies), or accident and health insurance contracts with a life feature (other than those to which section 809(d)(5) applies). For purposes of section 809(d)(6) and this subparagraph, the term ''premiums'' means the net amount of the premiums and other consideration attributable to such contracts taken into account under section 809(c)(1). The deduction allowed by section 809(d)(6) and this subparagraph for the taxable year and all preceding taxable years shall not exceed 50 percent of the net amount of the premiums attributable to such contracts for the taxable year. For example, assume that premiums attributable to group life insurance and group accident and health insurance contracts are $103,000 for the taxable year 1962. Assume further that there are $3,000 of return premiums attributable to such contracts for the taxable year. Under the provisions of

section 809(d)(6) and this subparagraph, a deduction (determined without regard to section 809(f) of $2,000 (2 percent of $100,000 ($103,000 − $3,000)) is allowed. Assuming that the company continues to receive net premiums of $100,000 attributable to such contracts for 15 years, the cumulative amount of these deductions is $30,000 ($2,000 for 15 years). If, in the sixteenth year, net premiums attributable to such contracts amount to $60,000, no deduction shall be allowed under section 809(d)(6) and this subparagraph since the cumulative amount of these deductions ($30,000) equals 50 percent of the current year's premiums ($60,000) from such contracts.

(ii) In computing the deduction under section 809(d)(6), the determination as to when the 50 percent limitation on such deduction has been reached shall be based upon the amount allowed as a deduction for the taxable year and all preceding taxable years after the application of the limitation provided in section 809(f) and § 1.809–7. Thus, if in the example set forth in paragraph (c) of § 1.809–7 the application of the limitation provided by section 809(f) limited the deduction allowed for the taxable year under section 809(d)(6) to $3,250,000, then for purposes of determining the 50 percent limitation on such deduction, only $3,250,000 (the amount allowed) shall be taken into account.

(iii) For purposes of determining whether the 50 percent limitation applies to any taxable year, the deduction provided by section 809(d)(6) for all preceding taxable years shall be taken into account, irrespective of whether or not the life insurance company claimed a deduction for these amounts for such preceding taxable years.

(iv) See section 809(f) and § 1.809–7 for limitation of the deduction provided by this subparagraph.

(7) *Assumption by another person of liabilities under insurance, etc., contracts.* (i) The consideration (other than consideration arising out of reinsurance ceded as defined in paragraph (a)(1)(iii) of § 1.809–4) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto) of the taxpayer.

(ii) For purposes of section 809(d)(7) and this subparagraph, the term *assumption reinsurance* means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809–4).

(iii) The provisions of section 809(d)(7) and this subparagraph may be illustrated by the following example:

Example. During the taxable year 1958, T, a life insurance company, transferred a block of insurance policies and made a payment of $50,000 to R, a life insurance company, under an arrangement whereby R became solely liable to the policyholders on the policies transferred by T. Under the provisions of section 809(d)(7) and this subparagraph, T is allowed a deduction of $50,000 for the taxable year 1958. For the treatment by R of this $50,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809–4. See section 806(a) and § 1.806–3 for the adjustments in reserves and assets to be made by T and R as a result of this transaction.

(8) *Tax-exempt interest, dividends, etc.* (i) Each of the following items:

(a) The life insurance company's share of interest which under section 103 is excluded from gross income;

(b) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3) and paragraph (d)(2)(i) of § 1.804–2) computed with respect to the life insurance company's share of such interest; and

(c) The deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B) and subdivision (ii) of this subparagraph) computed with respect to the life insurance company's share of the dividends received.

(ii) The modification contained in section 809(d)(8)(B) provides the method for applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of section 809(d)(8)(A)(iii) and subdivision (i)*(c)* of this subparagraph. Under this method, the sum of the deductions allowed by sections 243(a)(1) (relating to dividends received by corporations), 244(a) (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations) shall be limited to 85 percent of the gain from operations computed without regard to:

(a) The deductions provided by section 809(d) (3), (5), and (6);

(b) The operations loss deductions provided by section 812; and

(c) The deductions allowed by sections 243(a)(1), 244(a), and 245.

If a life insurance company has a loss from operations (as determined under sec. 812) for the taxable year, the limitation provided in section 809(d)(8)(B) and this subdivision shall not be applicable for such taxable year. In that event, the deductions provided by sections 243(a)(1), 244(a), and 245 shall be allowable for all tax purposes to the life insurance company for such taxable year without regard to such limitation. If the life insurance company does not have a loss from operations for the taxable year, however, the limitation shall be applicable for all tax purposes for such taxable year. In determining whether a life insurance company has a loss from operations for the taxable year under section 812, the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be computed without regard to the limitation provided in section 809(d)(8)(B) and this subdivision.

(9) *Investment expenses, etc.* (i) The amount of investment expenses to the extent not allowed as a deduction under section 804(c)(1) in computing investment yield. For example, if a deduction in the amount of $100,000 is claimed for investment expenses, which amount includes general expenses assigned to or included in investment expenses, and due to the operation of the limitation provided by section 804(c)(1) only $85,000 is allowed, then the excess ($15,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(ii) The amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income. For example, if gross investment income under section 804(b) equals $400,000, and the sum of the deductions allowable under section 804(c) equals $425,000, then the excess ($25,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(iii) In determining the amount of the deductions allowed under subdivisions (i) and (ii) of this subparagraph, a life insurance company shall first take such deductions to the full extent allowable under section 804(c)(1), and any amount which is allowed as a deduction under section 804(c) shall not again be allowed as a deduction under section 809(d)(9).

(10) *Small business deduction.* The small business deduction as determined under section 804(a)(4).

(11) *Certain mutualization distributions.* The amount of distributions to shareholders actually made by the life insurance company in 1958, 1959, 1960, and 1961 in acquisition of stock pursuant to a plan of mutualization adopted by the company before January 1, 1958. If such deduction is claimed, there must be attached to the return of the company claiming such deduction a certified copy of the plan of mutualization and proof that such plan was adopted prior to January 1, 1958. See section 809(g) and §1.809–8 for limitation of such deduction.

(12) *Other deductions.* Except as modified by section 809(e) and §1.809–6, all other deductions allowed under subtitle A of the Code for purposes of computing taxable income to the extent not allowed as a deduction in computing investment yield. For example, a life insurance company shall be allowed a deduction under section 809(d)(12) and this subparagraph for amounts representing premiums charged itself with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)) in accordance with the rules prescribed in sections 162 and 404 and the regulations thereunder, to the extent that a deduction for such amounts is not allowed under section 804(c)(1) and paragraph (b)(1) of §1.804–4 or section 809(d)(9) and subparagraph (9) of this paragraph.

(b) *Denial of double deduction.* Nothing in section 809(d) shall permit the same item to be deducted more than once in determining gain or loss from operations. For example, if an item is allowed as a deduction for the taxable year by reason of its being a loss incurred within such taxable year (whether or not ascertained) under section 809(d)(1), such item, or any portion thereof, shall not also be allowed as a deduction for such taxable year under section 809(d)(2).

[T.D. 6535, 26 FR 527, Jan. 20, 1961, as amended by T.D. 6610, 27 FR 8718, Aug. 31, 1962; T.D. 6886, 31 FR 8687, June 23, 1966; T.D. 6992, 34 FR 827, Jan. 18, 1969]

§ 1.809–6 Modifications.

Under section 809(e), the deductions allowed under section 809(d)(12) and paragraph (a)(12) of § 1.809–5 (relating to other deductions) are subject to the following modifications:

(a) *Interest.* No deduction shall be allowed under section 163 for interest in respect of items described in section 810(c) since such interest is taken into account in the determination of required interest under section 809.

(b) *Bad debts.* No deduction shall be allowed for an addition to reserves for bad debts under section 166(c). However, a deduction for specific bad debts shall be allowed to the extent that such deduction is allowed under section 166 and the regulations thereunder. In the case of a loss incurred on the sale of mortgaged or pledged property, see § 1.166–6 of this chapter.

(c) *Charitable, etc., contributions and gifts.* (1) The deduction by a life insurance company in any taxable year for a charitable contribution (as defined in section 170(c)) shall be limited to 5 percent of the gain from operations (as determined under section 809(b)(1)), computed without regard to any deductions for:

(i) Charitable contributions under section 170;

(ii) Dividends to policyholders under section 811(b);

(iii) Certain nonparticipating contracts under section 809(d)(5);

(iv) Group life insurance contracts and group accident and health insurance contracts under section 809(d)(6);

(v) Tax-exempt interest, dividends, etc., under section 809(d)(8); and

(vi) Any operations loss carryback to the taxable year under section 812.

(2) In applying the first sentence of section 170(b)(2) as contained in section 170 or, in the case of taxable years beginning after December 31, 1969, section 170(d)(2)(B) as contained in section 170A, any excess of the charitable contributions made by a life insurance company in a taxable year over the amount deductible in such year under the limitation contained in subparagraph (1) of this paragraph, shall be reduced to the extent that such excess:

(i) Reduces life insurance company taxable income (computed without regard to section 802(b)(3)) for the purpose of determining the offsets referred to in section 812(b)(2); and

(ii) Increases an operations loss carryover under section 812 for a succeeding taxable year.

(3) The application of the rules provided in section 809(e)(3) and this paragraph may be illustrated by the following example:

Example. Assume that life insurance company P is organized on January 1, 1958, and has a loss from operations for that year in the amount of $100,000 which is an operations loss carryover to 1959. In 1959, company P has a gain from operations and tax base (computed without regard to section 802(b)(3)) of $100,000 before the allowance of a deduction for a $5,000 charitable contribution made in 1959 and before the application of the operations loss carryover from 1958. Under section 170(b)(2), the operations loss carryover from 1958 is first applied to eliminate the $100,000 gain from operations and tax base in 1959 and the $5,000 charitable contribution carryover would (except for the limitation contained in this paragraph) become a charitable contribution carryover to 1960. However, for the purpose of computing the offsets referred to in section 812(b)(2), the $5,000 charitable contribution is applied to reduce the gain from operations and tax base for 1959 to $95,000 before the application of the operations carryover from 1958. Since only $95,000 of the $100,000 loss from operations in 1958 is an offset for 1959, the remaining $5,000 becomes an operations loss carryover to 1960. Accordingly, under the limitation contained in this paragraph, the charitable contributions carryover provided under the second sentence of section 170(b)(2) is eliminated.

(d) *Amortizable bond premium.* No deduction shall be allowed under section 171 for the amortization of bond premiums since a special deduction for such premiums is specifically taken into account under section 818(b).

(e) *Net operating loss deduction.* No deduction shall be allowed under section 172 since section 812 allows an ‘‘operations loss deduction’’.

(f) *Partially tax-exempt interest.* No deduction shall be allowed under section

242 for partially tax-exempt interest since section 809(d)(8) allows a deduction for such interest.

(g) *Dividends received.* No deduction shall be allowed under sections 243, 244, and 245 for dividends received since section 809(d)(8) allows a deduction for such dividends.

[T.D. 6535, 26 FR 529, Jan. 20, 1961, as amended by T.D. 7207, 37 FR 20797, Oct. 5, 1972]

§ 1.809–7 Limitation on certain deductions.

(a) *In general.* Section 809(f)(1) limits the deductions under section 809(d) (3), (5), and (6), relating to deductions for dividends to policyholders, certain nonparticipating contracts, and group life, accident, and health insurance contracts, respectively. This limitation provides that the amount of such deductions shall not exceed the sum of (1) the amount (if any) by which the gain from operations for the taxable year (determined without regard to such deductions) exceeds the taxpayer's taxable investment income for such year, plus (2) $250,000.

(b) *Application of limitation.* Section 809(f)(2) provides a priority system for applying the limitation contained in section 809(f)(1) and paragraph (a) of this section. Under this priortity system, the limitation shall be applied in the following order:

(1) For taxable years beginning before January 1, 1962:

(i) First to the amount of the deduction under section 809(d)(6) (relating to group life, accident, and health insurance);

(ii) Then to the amount of the deduction under section 809(d)(5) (relating to certain nonparticipating contracts); and

(iii) Finally to the amount of the deduction under section 809(d)(3) (relating to dividends to policyholders).

(2) For taxable years beginning after December 31, 1961, the limitation shall be applied in the following order:

(i) First to the amount of the deduction under section 809(d)(3);

(ii) Then to the amount of the deduction under section 809(d)(6); and

(iii) Finally to the amount of the deduction under section 809(d)(5).

Thus, for taxable years beginning after December 31, 1961, the limitation and priority system would operate first to disallow a deduction under section 809(d)(5), then a deduction under section 809(d)(6), and finally a deduction under section 809(d)(3). For purposes of applying the 50 percent limitation contained in section 809(d)(6) with respect to a taxable year beginning after December 31, 1961, the amount of the deductions for taxable years beginning before January 1, 1962, shall be determined by applying the priortity system contained in subparagraph (1) of this paragraph.

(c) *Illustration of principles.* The operation of the limitation and priority system provided by section 809(f) and this section may be illustrated by the following examples:

Example 1. Assume the following facts with respect to M, a life insurance company, for the taxable year 1958:

Gain from operations computed without regard to the deductions under sec. 809(d) (3), (5), and (6)	$100,000,000
Taxable investment income	83,000,000
Tentative deduction for group life, accident, and health insurance under sec. 809(d)(6)	4,000,000
Tentative deduction for certain nonparticipating contracts under sec. 809(d)(5)	6,000,000
Tentative deduction for dividends to policyholders under sec. 809(d)(3)	10,000,000

In order to determine the limitation on the deductions under section 809(d) (3), (5), and (6), M would make up the following schedule:

(1) Statutory amount provided under sec. 809(f)(1)		$250,000
(2) Gain from operations computed without regard to the deductions under sec. 809(d) (3), (5), and (6)	$100,000,000	
(3) Taxable investment income	83,000,000	
(4) Excess of item (2) over item (3)		17,000,000
(5) Limitation on deductions under sec. 809(d) (3), (5), and (6) (item (1) plus item (4))		17,250,000

Since the total tentative deductions under section 809(d) (3), (5), and (6) ($20,000,000) exceeds the limitation on such deductions ($17,250,000), M would make up the following schedule to determine the application of the priority system:

(6) Maximum possible deduction under sec. 809(d) (3), (5), and (6) (item (5))	$17,250,000
(7) Deduction for group life, accident, and health insurance under sec. 809(d)(6) (not in excess of item (6))	4,000,000

(8) Maximum possible deduction under sec. 809(d)(5) (item (6) less item (7))	13,250,000
(9) Deduction for certain nonparticipating contracts under sec. 809(d)(5) (not in excess of item (8))	6,000,000
(10) Maximum possible deduction under sec. 809(d)(3) (item (8) less item (9))	7,250,000
(11) Deduction for dividends to policyholders under sec. 809(d)(3) (not in excess of item (10))	7,250,000

Thus, as a result of the application of the limitation and priority system for the taxable year 1958, M shall be allowed a deduction of $4,000,000 under section 809(d)(6), $6,000,000 under section 809(d)(5), and only $7,250,000 of the $10,000,000 tentative deduction under section 809(d)(3).

Example 2. The facts are the same as in example 1, except that the taxable year is 1962. Since the total tentative deductions under section 809(d) (3), (5), and (6) ($20,000,000) exceeds the limitation on such deductions ($17,250,000), M would make up the following schedule to determine the application of the priority system:

(1) Maximum possible deductions under sec. 809(d) (3), (5), and (6) (item (5) in example 1)	$17,250,000
(2) Deduction for dividends to policyholders under sec. 809(d)(3) (not in excess of item (1))	10,000,000
(3) Maximum possible deduction under sec. 809(d)(6) (item (1) less item (2))	7,250,000
(4) Deduction for certain accident, health, and group life insurance under sec. 809(d)(6) (not in excess of item (3))	4,000,000
(5) Maximum possible deduction under sec. 809(d)(5) (item (4) less item (5))	3,250,000
(6) Deduction for certain nonparticipating contracts under sec. 809(d)(5) (not in excess of item (5))	3,250,000

Thus, as a result of the application of the limitation and priority system for the taxable year 1962, M shall be allowed a deduction of $10,000,000 under section 809(d)(3), $4,000,000 under section 809(d)(6), and only $3,250,000 of the $6,000,000 tentative deduction under section 809(d)(5).

[T.D. 6535, 26 FR 530, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8688, June 23, 1966]

§ 1.809–8 Limitation on deductions for certain mutualization distributions.

(a) *Deduction not to reduce taxable investment income.* Section 809(g)(1) limits the deduction under section 809(d)(11) for certain mutualization distributions. This limitation provides that such deduction shall not exceed the amount (if any) by which the gain from operations for the taxable year, computed without regard to such deduction (but after the application of the limitation contained in section 809(f) and § 1.809–7), exceeds the taxpayer's taxable investment income for such year.

(b) *Deduction not to reduce tax below that imposed by 1957 law.* Section 809(g)(2) further limits the deduction under section 809(d)(11). Under section 809(g)(2), such deduction shall be allowed only to the extent that it (after the application of all other deductions) does not reduce the tax imposed by section 802(a)(1) for the taxable year below the amount of tax which would have been imposed for such taxable year if the law in effect for 1957 applied for such taxable year. If such deduction is claimed for 1958 (or 1959), the company shall attach to its return a schedule showing what its tax for 1958 (or 1959) would have been had such tax been computed under the law in effect for 1957.

(c) *Application of section 815.* Section 809(g)(3) provides that any portion of a distribution which is allowed as a deduction under section 809(d)(11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distributions made in 1959, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(e)(2)(B) (relating to adjustment in allocation ratio for certain distributions after December 31, 1958).

[T.D. 6535, 26 FR 530, Jan. 20, 1961]

§ 1.809–9 Computation of the differential earnings rate and the recomputed differential earnings rate.

(a) *In general.* Neither the differential earnings rate under section 809(c) nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under section 809(f)(3) may be less than zero.

(b) *Definitions*—(1) *Recomputed differential earnings amount.* The recomputed differential earnings amount, with respect to any taxable year, is the amount equal to the product of—

(i) The life insurance company's average equity base for the taxable year; multiplied by

(ii) The recomputed differential earnings rate for that taxable year.

(2) *Recomputed differential earnings rate.* The recomputed differential earnings rate for any taxable year equals the excess of—

(i) The imputed earnings rate for the taxable year; over

(ii) The average mutual earning rate for the calendar year in which the taxable year begins.

(c) *Effective date.* The regulations are effective for all taxable years beginning after December 31, 1986.

[T.D. 8499, 58 FR 64899, Dec. 10, 1993]

§ 1.809–10 Computation of equity base.

(a) *In general.* For purposes of section 809, the equity base of a life insurance company includes the amount of any asset valuation reserve and the amount of any interest maintenance reserve.

(b) *Effective date.* This section is effective for taxable years ending after December 31, 1991.

[T.D. 8484, 58 FR 47061, Sept. 7, 1993, as amended by T.D. 8564, 59 FR 49579, Sept. 29, 1994]

§ 1.810–1 Taxable years affected.

Sections 1.810–2 through 1.810–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6535, 26 FR 531, Jan. 20, 1961]

§ 1.810–2 Rules for certain reserves.

(a) *Adjustment for decrease or increase in certain reserve items*—(1) *Adjustment for decrease.* Section 810(a) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year exceeds the sum of such items at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the amount of such excess shall be taken into account as a net decrease referred to in section 809(c)(2) and paragraph (a)(2) of § 1.809–4 in determining gain or loss from operations.

(2) *Adjustment for increase.* Section 810(b) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items at the beginning of the taxable year, the amount of such excess shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations.

(b) *Items taken into account.* The items described in section 810(c) and referred to in section 810 (a) and (b) and paragraph (a) of this section are:

(1) The life insurance reserves (as defined in section 801(b) and § 1.801–4);

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2) and § 1.801–5;

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this subparagraph) life, health, or accident contingencies;

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto); and

(5) Premiums received in advance, and liabilities for premium deposit funds.

(6) Special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

For purposes of this paragraph, the same item shall be counted only once and deficiency reserves (as defined in section 801(b)(4) and paragraph (e)(4) of

§ 1.801–4) shall not be taken into account.

(c) *Special rules.* For purposes of section 810 (a) and (b) and paragraph (a) of this section, in determining whether there is a net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year, the following rules shall apply:

(1) *Computation of net increase or decrease in reserves.* The sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year shall be the aggregate of the sums of each of such items at the beginning of the taxable year. The sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year shall be the aggregate of the sums of each of such items at the end of the taxable year. However, in order to determine whether there is a net increase or decrease in such items for the taxable year, the aggregate of the sums of the items at the end of the taxable year must first be reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1).

(2) *Effect of change in basis in computing reserves.* Any increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810 (a) or (b) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of § 1.810–3.

(3) *Effect of section 818(c) election.* If a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), the sum of such reserves at the beginning and end of all taxable years (including the first taxable year) for which the election applies shall be the sum of such reserves computed on such net level premium basis.

(4) *Cross references.* For taxable years beginning before January 1, 1970, see section 810(e) (as in effect for such years) and § 1.810–4 for special rules for determining the net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section in the case of certain voluntary employees' beneficiary associations. For similar special rules in the case of life insurance companies issuing variable annuity contracts, see section 801(g)(4) and the regulations thereunder.

(d) *Illustration of principles.* The provisions of section 810 (a) and (b) and this section may be illustrated by the following examples:

Example 1. Assume the following facts with respect to R, a life insurance company:

Sum of items described in section 810(c) (1) through (6) at beginning of taxable year	$940
Sum of items described in section 810(c) (1) through (6) at end of taxable year	1,060
Required interest (as defined in section 809(a)(2))	70
Investment yield (as defined in section 804(c)) ..	100
Amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)	70

In order to determine the adjustment for decrease or increase in the sum of the items described in section 810(c) for the taxable year, R must first reduce the sum of such items at the end of the taxable year ($1,060) by the amount of investment yield ($70) not included in gain or loss from operations for the taxable year by reason of section 809(a)(1). Since the adjusted sum of such items at the end of the taxable year, $990 ($1,060 minus $70), exceeds the sum of such items at the beginning of the taxable year, $940, the excess of $50 ($990 minus $940) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations.

Example 2. Assume the facts are the same as in example 1, except that the sum of the items described in section 810(c) at the beginning of the taxable year is $1000. Since the sum of the items described in section 810(c) at the beginning of taxable year, $1000, exceeds the sum of such items at the end of the taxable year after adjustment for the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), $990 ($1060 minus $70), the excess of $10 ($1000 minus $990) shall be taken into account as a net decrease under section 809 (c)(2) and paragraph (a)(2) of § 1.809–4 in determining gain or loss from operations.

Example 3. Assume the following facts with respect to S, a life insurance company:

Sum of items described in section 810(c) (1) through (6) at beginning of taxable year	$1,970
Sum of items described in section 810(c) (1) through (6) at the end of taxable year	2,040

Required interest (as defined in section 809(a)(2))	60
Investment yield (as defined in section 804(c))	40
Amount of investment yield not included in gain or loss from operations by reason of section 809(a)(1)	40

Under the provisions of section 809(a)(1), since the required interest ($60) exceeds the investment yield ($40), the share of each and every item of investment yield set aside for policyholders and not included in gain or loss from operations for the taxable year shall be 100 percent. Thus, applying the provisions of section 810 (a) and (b), the sum of the items described in section 810(c) at the end of the taxable year ($2,040) must first be reduced by the entire amount of the investment yield ($40) in order to determine the net increase or decrease in the sum of such items for the taxable year. Since the adjusted sum of such items at the end of the taxable year, $2,000 ($2,040 minus $40), is greater than the sum of such items at the beginning of the taxable year, $1,970, the excess of $30 ($2,000 minus $1,970) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of §1.809–5 in determining gain or loss from operations. No additional deduction is allowed under section 809(d) for the amount ($20) by which the required interest exceeds the investment yield for the taxable year.

Example 4. Assume the facts are the same as in example 1, except that as a result of a change in the basis used in computing an item described in section 810(c) during the taxable year, the sum of such items at the end of the taxable year is $1,200. Under the provisions of paragraph (c)(2) of this section, any increase or decrease in the sum of the section 810(c) items for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810 (a) and (b). Thus, for purposes of section 810 (a) and (b), the sum of the items described in section 810(c) at the end of the taxable year shall be $1,060 (the amount computed without regard to the change in basis) and S shall treat the $50 computed in the manner described in example 1 as a net increase under section 809(d)(2) and paragraph (a)(2) of §1.809–5 in determining its gain or loss from operations for the taxable year. The amount of the increase in the section 810(c) items which is attributable to the change in basis during the taxable year, $140 ($1,200 minus $1,060), shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of §1.810–3.

Example 5. The life insurance reserves of M, a life insurance company, computed with respect to contracts for which such reserves are determined on a recognized preliminary term basis amount to $100 on January 1, 1960, and $110 on December 31, 1960. For the taxable year 1960, M elects to revalue such reserves on a net level premium basis under section 818(c). Such reserves computed under section 818(c) amount to $115 on January 1, 1960, and $127 on December 31, 1960. Under the provisions of paragraph (c)(3) of this section, a company which makes the section 818(c) election must use the net level premium basis in computing the sum of its life insurance reserves at the beginning and end of all taxable years for which the election applies. Thus, for purposes of section 810 (a) and (b), in determining whether there is a net increase or decrease in the sum of the section 810(c) items for the taxable year 1960, M shall include $115 as its reserves with respect to such contracts under section 810(c)(1) at the beginning of the taxable year and $127 as its reserves with respect to such contracts under section 810(c)(1) at the end of the taxable year.

[T.D. 6535, 26 FR 531, Jan. 20, 1961, as amended by T.D. 7163, 37 FR 4189, Feb. 29, 1972; T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§ 1.810–3 Adjustment for change in computing reserves.

(a) *Reserve strengthening or weakening.* Section 810(d)(1) provides that if the basis for determining any item referred to in section 810(c) and paragraph (b) of §1.810–2 at the end of any taxable year differs from the basis for such determination at the end of the preceding taxable year, then so much of the difference between:

(1) The amount of the item at the end of the taxable year, computed on the new basis, and

(2) The amount of the item at the end of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account as follows:

(i) If the amount of the item at the end of the taxable year computed on the new basis exceeds the amount of the item at the end of the taxable year computed on the old basis, 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years as a net increase to which section 809(d)(2) and paragraph (a)(2) of §1.809–5 applies; or

(ii) If the amount of the item at the end of the taxable year computed on the old basis exceeds the amount of the item at the end of the taxable year computed on the new basis, 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809 (c)(2) and paragraph (a)(2) of § 1.809–4 applies.

(b) *Illustration of principles.* The provisions of section 810(d)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example 1. Assume that the amount of an item described in section 810(c) of L, a life insurance company, at the beginning of the taxable year 1959 is $100. Assume that at the end of the taxable year 1959, as a result of a change in the basis used in computing such item during the taxable year, the amount of the item (computed on the new basis) is $200 but computed on the old basis would have been $150. Since the amount of the item at the end of the taxable year computed on the new basis, $200, exceeds the amount of the item at the end of the taxable year computed on the old basis, $150, by $50, 1/10 of the amount of such excess, or $5, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1959. Any increase (or decrease) in the sum of the section 810(c) items computed on the old basis at the end of the taxable year 1959 ($150) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items computed on the old basis at the beginning of the taxable year 1959 ($100), shall be taken into account in the manner prescribed in section 810 (a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1959.

Example 2. Assume the facts are the same as in example 1, and that the sum of the items described in section 810(c) (computed on the new basis) is $200 on January 1, 1960, and $260 on December 31, 1960. Under the provisions of section 810(d)(1), as a result of the reserve strengthening attributable to the change in basis which occurred in 1959, L would include $5 (computed in the manner described in example 1) as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations for 1960. In addition to this amount, any increase (or decrease) in the sum of the items described in section 810(c) at the end of the taxable year 1960 ($260) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items at the beginning of the taxable year 1960 ($200), shall be taken into account in the manner prescribed in section 810 (a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1960.

(c) *Termination as life insurance company.* Section 810(d)(2) provides, subject to the provisions of section 381(c)(22) and the regulations thereunder (relating to carryovers in certain corporate readjustments), that if for any taxable year a company which previously was a life insurance company no longer meets the requirements of section 801(a) and paragraph (b) of § 1.801–3 (relating to the definition of a life insurance company), the balance of any adjustments remaining to be made under section 810(d)(1) and paragraph (a) of this section shall be taken into account for the preceding taxable year.

(d) *Illustration of principles.* The provisions of section 810(d)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume the facts are the same as in example 1 of paragraph (b) of this section, except that for the taxable year 1962, L no longer meets the requirements of section 801(a) (relating to the definition of a life insurance company) and that the provisions of section 381(c)(22) are not applicable. Under the provisions of section 810 (d)(2), the entire balance of the adjustment remaining to be made with respect to the change in basis which occurred in 1959, 8/10 of $50, or $40, shall be taken into account for the taxable year 1961, the last year L was a life insurance company. Thus, for the taxable year 1961, the total amount to be taken into account by L as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations shall be $45. Of this amount, $5 (1/10 of $50) represents the amount determined under the provisions of section 810(d)(1), and $40 represents the amount determined under the provisions of section 810(d)(2).

(e) *Effect of preliminary term election.* (1) Section 810(d)(3) provides that if a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), such election shall not be treated as a change in basis within the meaning of section 810(d)(1) and paragraph (a) of this section. Thus, any increase or decrease in reserves attributable to such election shall not be taken into account under section 810(d)(1) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810 (a) and (b) and paragraph (a) of § 1.810–2. See paragraph (c)(3) of § 1.810–2.

(2) Section 810(d)(3) further provides that where an election under section 818(c) would apply to an item referred to in section 810(c) but for the fact that the basis used in computing such item has actually been changed, any increase or decrease in such item attributable to such actual change in basis shall be subject to the adjustment required under section 810(d)(1) and paragraph (a) of this section. In such a case, however, for purposes of section 810(d)(1)(B) and paragraph (a)(2) of this section, the amount of such item at the end of the taxable year computed on the old basis shall be the amount of such item at the end of the taxable year computed as if the election under section 818(c) applied in respect of such item for the taxable year.

(f) *Illustration of principles.* The provisions of section 810(d)(3) and paragraph (e) of this section may be illustrated by the following examples:

Example 1. Assume that S, a life insurance company which computes its life insurance reserves on a 3-percent assumed rate and the Commissioner's reserve valuation method (one of the recognized preliminary term reserve methods), elects to revalue such reserves on a net level premium method under section 818(c) and that the significant facts are as follows:

	Jan. 1, 1958	Dec. 31, 1958
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	100	118
Reserves at 3-percent assumed rate, after restatement under section 818(c)	110	131

Under the provisions of section 810(d)(3), an election under section 818(c) is not treated as a change in basis for purposes of section 810(d)(1). Accordingly, the increase of $21 ($131 minus $110) attributable to such election shall not be subject to the adjustment provided by section 810(d)(1) but shall be taken into account in the manner prescribed in section 810(b). For purposes of determining the amount to be taken into account under section 810(b), the reserves with respect to the contracts subject to the section 818(c) election shall be $110 at the beginning of the taxable year 1958 and $131 at the end of the taxable year 1958. However, as a result of making the election under section 818(c), the difference ($10) between the reserves computed on the preliminary term basis on January 1, 1958 ($100) and the reserves restated on the net level premium basis on January 1, 1958 ($110) shall not be taken into account under section 809(d) for the year 1958, or for any subsequent taxable year.

Example 2. Assume the facts are the same as in example 1, except that during the taxable year 1959, S actually changed from the preliminary term basis to a net level premium basis which was identical with the net level premium basis used under the section 818(c) election and that the significant facts are as follows:

	Jan. 1, 1959	Dec. 31, 1959
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	118	127
Reserves at 3-percent assumed rate, after restatement under section 818(c)	131	142
Strengthened reserves at 3-percent assumed rate and net level premium method	....	142

Under the provisions of section 810(d)(3), if a company which has made an election under section 818(c) which has not been revoked actually changes the basis used by it in computing the reserves subject to such election, any increase or decrease in reserves attributable to such change in basis shall be taken into account in the manner prescribed in section 810(d)(1). Since S actually changed to the same basis which it used in computing its reserves under section 818(c), the reserves at the end of the taxable year computed on the new basis ($142) are the same as the reserves at the end of the taxable year computed on the old basis ($142), i.e., the basis which would have applied under section 818(c) if the election applied for 1959. Accordingly, no adjustment under section 810(d)(1) is required.

Example 3. Assume the facts are the same as in example 1, except that during the taxable year 1960, S actually changed the basis used by it in computing its reserves on a certain block of contracts subject to the election under section 818(c) and that the significant facts with respect to this block of contracts are as follows:

	Jan. 1, 1960	Dec. 31, 1960
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	50	63
Reserves at 3-percent assumed rate, after restatement under section 818(c)	60	75
Strengthened reserves at 2-percent assumed rate and net level premium method	....	95

Under the provisions of section 810(d)(3), the amount of the reserves subject to the section

818(c) election at the end of the taxable year computed on the old basis shall be the amount of such reserves at the end of the taxable year determined under section 818(c) ($75). Since the reserves at the end of the taxable year computed on the new basis, $95, exceed the reserves at the end of the taxable year computed on the old basis, $75, by $20, 1/10 of the excess of $20, or $2, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1960. For purposes of determining whether there is a net increase or decrease in the sum of the items described in section 810(c) for the taxable year 1960 under section 810 (a) or (b), the sum of the reserves with respect to such block of contracts shall be $60 at the beginning of the taxable year and $75 at the end of the taxable year (the amount of such reserves computed under section 818(c) at the beginning and end of the taxable year). The difference ($10) between the reserves computed on the preliminary term basis on January 1, 1960 ($50) and the reserves restated on the net level premium basis on January 1, 1960 ($60) shall not be taken into account under section 809(d) for the year 1960, or for any subsequent taxable year.

[T.D. 6535, 26 FR 532, Jan. 20, 1961]

§ 1.810–4 Certain decreases in reserves of voluntary employees' beneficiary associations.

(a) *Decreases due to voluntary lapses of policies issued before January 1, 1958.* (1) Section 810(e) provides that if for any taxable year a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes an election in the manner provided in section 810(e)(3) and paragraph (b) of this section, only 11½ percent of any decrease in life insurance reserves (as defined in section 801(b) and § 1.801–4) attributable to the voluntary lapse on or after January 1, 1958, of any policy issued prior to that date shall be taken into account under section 810 (a) or (b) and paragraph (a) of § 1.810–2 in determining the net increase or decrease in the sum of the items described in section 810(c) during the taxable year. In applying the preceding sentence, the decrease in the reserve for any policy shall be determined by reference to the amount of such reserve at the beginning of the taxable year, reduced by any amount allowable as a deduction under section 809(d)(1) and paragraph (a)(1) of § 1.809–5 in respect of such policy by reason of such lapse. The election under section 810(e) shall be adhered to in computing the company's gain or loss from operation for the taxable year for which the election is made and for all subsequent taxable years, unless consent to revoke such election is obtained from the Commissioner.

(2) The application of the election provided under section 810(e) and subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, M, a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes the election under section 810(e). Assume the following facts with respect to a policy issued in 1955 which voluntarily lapsed during the taxable year:

(1) Life insurance reserve on January 1, 1960	$600
(2) Amount allowable as a deduction under sec. 809(d)(1)	200
(3) Decrease in life insurance reserves for sec. 810(e) purposes (item (1) minus item (2))	400
(4) Amount taken into account under sec. 810 (a) and (b) by reason of sec. 810(e) election (11 1/2%×$400)	46

Under the provisions of section 810(e) and subparagraph (1) of this paragraph, M would include $46 as its life insurance reserve with respect to such policy under section 810(c)(1) at the beginning of the taxable year 1960 for purposes of determining the net increase or decrease in the sum of the items described in section 810(c) for the taxable year under section 810 (a) or (b).

(b) *Time and manner of making election.* The election provided by section 810(e)(3) shall be made in a statement attached to the life insurance company's income tax return for the first taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which the company desires the election to apply falls before January 20, 1961, the election provided by section 810(e)(3) may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before April 21, 1961. The statement shall indicate that the company meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, and has made the election provided under section 810(e) and paragraph (a) of this section. The statement shall set forth the following information with respect to each policy described in paragraph (a) of this section which has voluntarily lapsed during such year:

(1) Type of policy.

(2) Date issued.

(3) Date lapsed.

(4) Reason for lapse.

(5) Policy reserve as of beginning of taxable year.

(6) Deduction allowable under section 809(d)(1) and paragraph (a)(1) of § 1.809–5 during taxable year by reason of lapse.

(7) Decrease in policy reserve for section 810(e) purposes (excess of (5) over (6)).

In addition, the statement shall set forth the total of the amounts referred to in subparagraph (7) of this paragraph with respect to all policies described in paragraph (a) of this section which have voluntarily lapsed during the taxable year.

(c) *Scope of election.* An election made under section 810(e)(3) and paragraph (a) of this section shall be effective for the taxable year for which made and for all succeeding taxable years, unless consent to revoke the election is obtained from the Commissioner. However, for taxable years beginning prior to January 20, 1961, a company may revoke the election provided by section 810(e)(3) without obtaining consent from the Commissioner by filing, before April 21, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(d) *Disallowance of carryovers from pre-1958 losses from operations.* For any taxable year for which the election provided under section 810(e)(3) and paragraph (b) of this section is effective, the provisions of section 812(b)(1) and § 1.812–4 shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(e) *Effective date; cross reference.* The provisions of section 810(e) (as in effect for such years) and this section apply only with respect to taxable years beginning before January 1, 1970. For provisions relating to certain funded pension trusts applicable to taxable years beginning after December 31, 1969, see section 501(c)(18) and the regulations thereunder.

[T.D. 6535, 26 FR 533, Jan. 20, 1961, as amended by T.D. 7172, 37 FR 5619, Mar. 17, 1972]

§ 1.811–1 Taxable years affected.

Section 1.811–2, except as otherwise provided therein, is applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6535, 26 FR 534, Jan. 20, 1961]

§ 1.811–2 Dividends to policyholders.

(a) *Dividends to policyholders defined.* Section 811(a) defines the term *dividends to policyholders*, for purposes of part I, subchapter L, chapter 1 of the Code, to mean dividends and similar distributions to policyholders in their capacity as such. The term includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management. In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which during the taxable year contains a right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders. Similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company. However, the term does not include interest paid (as defined in section 805(e) and paragraph (b) of § 1.805–8) or return premiums (as defined in section 809(c) and paragraph (a)(1)(ii) of § 1.809–4). Thus, so-called excess-interest dividends and amounts returned by one life insurance company to another in respect of reinsurance ceded shall not be treated as dividends to policyholders even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of the management.

(b) *Amount of deduction*—(1) *In general.* Section 811(b)(1) provides, subject to the limitation of section 809(f), that the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders paid during the taxable year:

(i) Increased by the excess of the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, or

(ii) Decreased by the excess of the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year.

For the rule as to when dividends are considered paid, see section 561 and the regulations thereunder. For the determination of the amounts held as reserves for dividends to policyholders, see paragraph (c) of this section. For special provisions relating to the treatment of dividends to policyholders paid with respect to policies reinsured under modified coinsurance contracts, see section 820(c)(5) and the regulations thereunder.

(2) *Certain amounts to be treated as net decreases.* Section 811(b)(2) provides that if the amount determined under subparagraph (1)(ii) of this paragraph exceeds the dividends to policyholders paid during the taxable year, the amount of such excess shall be a net decrease referred to in section 809(c)(2).

(c) *Reserves for dividends to policyholders defined*—(1) *In general.* The term *reserves for dividends to policyholders,* as used in section 811(b)(1) (A) and (B) and paragraph (b)(1) of this section, means only those amounts:

(i) Actually held, or set aside as provided in subparagraph (2) of this paragraph and thus treated as actually held, by the company at the end of the taxable year, and

(ii) With respect to which, at the end of the taxable year or, if set aside, within the period prescribed in subparagraph (2) of this paragraph, the company is under an obligation, which is either fixed or determined according to a formula which is fixed and not subject to change by the company, to pay such amounts as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following the taxable year.

(2) *Amounts set aside.* (i) In the case of a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), all amounts set aside before the 16th day of the 3d month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(ii) In the case of a mutual savings bank subject to the tax imposed by section 594, all amounts set aside before the 16th day of the 4th month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(3) *1958 reserve for dividends to policyholders.* For purposes of section 811(b) and paragraph (b) of this section, the amounts held at the end of 1957 as reserves for dividends to policyholders payable during 1958 shall be determined as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied for 1957. Any adjustment in the reserves for dividends to policyholders at the beginning of 1957 required as a result of an understatement or overstatement of such reserves by the company shall be made to the balance of such reserves as of the beginning of 1957. For example, if at the beginning of 1957 the

reserves for dividends to policyholders are stated to be $100 and it is subsequently determined that such reserves should have been $90, the reserves at the beginning of 1957 shall be reduced by $10. Under no circumstances shall an adjustment required with regard to the beginning 1957 reserves be made to the reserves at the end of 1957.

(4) *Information to be filed.* Every company claiming a deduction for dividends to policyholders shall keep such permanent records as are necessary to establish the amount of dividends actually paid during the taxable year. Such company shall also keep a copy of the dividend resolution and any necessary supporting data relating to the amounts of dividends declared and to the amounts held or set aside as reserves for dividends to policyholders during the taxable year. The company shall file with its return a concise statement of the pertinent facts relating to its dividend policy for the year, the amount of dividends actually paid during the taxable year, and the amounts held or set aside as reserves for dividends to policyholders during the taxable year.

(d) *Illustration of principles.* The provisions of section 811(b) and this section may be illustrated by the following examples:

Example 1. On December 31, 1959, M, a life insurance company, held $200 as reserves for dividends to policyholders due and payable in 1960. On March 10, 1960, M set aside an additional $50 as reserves for dividends to policyholders due and payable in 1960. During the taxable year 1960, M paid $240 as dividends to its policyholders and at the end of the taxable year 1960, held $175 as reserves for dividends to policyholders due and payable in 1961. No additional amount was set aside before March 16, 1961, as reserves for dividends to policyholders due and payable in 1961. For the taxable year 1960, subject to the limitation of section 809(f), M's deduction for dividends to policyholders is $165, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1960		$240
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–59 (including amounts set aside as provided in paragraph (c)(2) of this section)	$250	
(b) Reserves for dividends to policyholders as of 12–31–60 –	175	
		75
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		$165

Example 2. On December 31, 1960, S, a life insurance company, held $100 as reserves for dividends to policyholders due and payable in 1961. During the taxable year 1961, S paid $125 as dividends to its policyholders and at the end of the taxable year 1961, held $110 as reserves for dividends to policyholders due and payable in 1962. No additional amount was set aside for dividends to policyholders as provided in paragraph (c)(2) of this section before March 16, 1961, or March 16, 1962. For the taxable year 1961, subject to the limitation of section 809(f), S's deduction for dividends to policyholders is $135, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Increased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–61	$110	
(b) Reserves for dividends to policyholders as of 12–31–60	100	
		10
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		$135

Example 3. Assume the facts are the same as in example 2, except that on December 31, 1960, the amount held as reserves for dividends to policyholders due and payable in 1961 is $250. For the taxable year 1961, S's deduction for dividends to policyholders is zero, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–60	$250	
(b) Reserves for dividends to policyholders as of 12–31–61	110	
		140
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		$0

Under the provisions of section 811(b)(2) and paragraph (b)(2) of this section, since the decrease in the reserves for dividends to policyholders during the taxable year, $140 ($250 minus $110), exceeds the dividends to policyholders paid during the taxable year 1961, $125, S shall include $15 (the amount of such excess) as a net decrease under section 809(c)(2) and paragraph (a)(2) of §1.809–4 in determining its gain or loss from operations for 1961.

[T.D. 6535, 26 FR 534, Jan. 20, 1961]

§ 1.811–3 Cross-reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and § 1.817A–1(a)(1)), *see* § 1.817A–1.

[T.D. 9058, 68 FR 24350, May 7, 2003]

§ 1.812–1 Taxable years affected.

Sections 1.812–2 through 1.812–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.812–2 Operations loss deduction.

(a) *Allowance of deduction.* Section 812 provides that a life insurance company shall be allowed a deduction in computing gain or loss from operations for any taxable year beginning after December 31, 1957, in an amount equal to the aggregate of the operations loss carryovers and operations loss carrybacks to such taxable year. This deduction is referred to as the operations loss deduction. The loss from operations (computed under section 809), is the basis for the computation of the operations loss carryovers and operations loss carrybacks and ultimately for the operations loss deduction itself. Section 809(e)(5) provides that the net operating loss deduction provided in section 172 shall not be allowed a life insurance company since the operations loss deduction provided in section 812 and this paragraph shall be allowed in lieu thereof.

(b) *Steps in computation of operations loss deduction.* The three steps to be taken in the ascertainment of the operations loss deduction for any taxable year beginning after December 31, 1957, are as follows:

(1) Compute the loss from operations for any preceding or succeeding taxable year from which a loss from operations may be carried over or carried back to such taxable year.

(2) Compute the operations loss carryovers to such taxable year from such preceding taxable years and the operations loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such operations loss carryovers and carrybacks in order to determine the operations loss deduction for such taxable year.

(c) *Statement with tax return.* Every life insurance company claiming an operations loss deduction for any taxable year shall file with its return for such year a concise statement setting forth the amount of the operations loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the operations loss deduction.

(d) *Ascertainment of deduction dependent upon operations loss carryback.* If a life insurance company is entitled in computing its operations loss deduction to a carryback which it is not able to ascertain at the time its return is due, it shall compute the operations loss deduction on its return without regard to such operations loss carryback. When the life insurance company ascertains the operations loss carryback, it may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the operations loss deduction for the taxable year with the inclusion of such carryback; or it may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations.* The following rules shall apply to all taxable years beginning after December 31, 1957:

(1) In determining the amount of any operations loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The loss from operations for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the operations loss deduction.

(3) The amount of the operations loss deduction which shall be allowed for

any taxable year shall be determined under the law applicable for that year.

(f) *Special rules.* For purposes of taxable years beginning after December 31, 1954, and before January 1, 1958:

(1) The amount of any:

(i) Loss from operations;

(ii) Operations loss carryback; and

(iii) Operations loss carryover

shall be computed as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) and section 381(c)(22) applied to such taxable years.

(2) A loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph) for such taxable years shall in no way affect the tax liability of any life insurance company for such taxable years. However, such loss may, to the extent allowed as an operations loss carryover under section 812, affect the tax liability of a life insurance company for a taxable year beginning after December 31, 1957. For example, for the taxable year 1956, X, a life insurance company, has a loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph). Such loss shall in no way affect X's tax liability for the taxable years 1956 (the year of the loss), 1955 (a year to which such loss shall be carried back), or 1957 (a year to which such loss shall be carried forward). However, to the extent allowed under section 812, any amount of the loss for 1956 remaining after such carryback and carryforward shall be taken into account in determining X's tax liability for taxable years beginning after December 31, 1957.

[T.D. 6535, 26 FR 536, Jan. 20, 1961]

§ 1.812–3 Computation of loss from operations.

(a) *Modification of deductions.* A loss from operations is sustained by a life insurance company in any taxable year, if and to the extent that, for such year, there is an excess of the sum of the deductions provided by section 809(d) over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) as determined under section 809(b)(3), and (2) the sum of the items of gross amount taken into account under section 809(c). In determining the loss from operations for purposes of section 812:

(i) No deduction shall be allowed under section 812 for the operations loss deduction.

(ii) The 85 percent limitation on dividends received provided by section 246 (b) as modified by section 809(d)(8)(B) shall not apply to the deductions otherwise allowed under:

(a) Section 243(a) in respect to dividends received by corporations,

(b) Section 244 in respect of dividends received on certain preferred stock of public utilities, and

(c) Section 245 in respect of dividends received from certain foreign corporations.

(b) *Illustration of principles.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. For the taxable year 1960, X, a life insurance company, has items taken into account under section 809(c) amounting to $150,000, its share of the investment yield amounts to $250,000, and total deductions allowed by section 809(d) of $375,000, exclusive of any operations loss deduction and exclusive of any deduction for dividends received. In 1960, X received as its share of dividends entitled to the benefits of section 243(a) the amount of $100,000. These dividends are included in X's share of the investment yield. X has no other deductions to which section 812(c) applies. On the basis of these facts, X has a loss from operations for the taxable year 1960 of $60,000, computed as follows:

Deductions for 1960	$375,000
Plus: Deduction for dividends received computed without regard to the limitation provided by sec. 246(b), as modified by sec. 809(d)(8)(B) (85% of $100,000)	85,000
Total deductions as modified by sec. 812(c)	460,000
Less: Sum of sec. 809(c) items and X's share of investment yield (including $100,000 of dividends)	400,000
Loss from operations for 1960	(60,000)

[T.D. 6535, 26 FR 536, Jan. 20, 1961]

§ 1.812–4 Operations loss carrybacks and operations loss carryovers.

(a) *In general*—(1) *Years to which loss may be carried.* In order to compute the operations loss deduction of a life insurance company the company must first determine the part of any losses from operations for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. Except as otherwise provided by this paragraph, a loss from operations for taxable years beginning after December 31, 1954, shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 5 taxable years succeeding the loss year. Except as limited by section 812(e)(2) and paragraph (b) of §1.812–6, if the life insurance company is a new company (as defined in section 812(e)(1)) for the loss year, the loss from operations shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 8 taxable years succeeding the loss year. In determining the span of years for which a loss from operations may be carried, taxable years in which a company does not qualify as a life insurance company (as defined in section 801(a)), or is not treated as a new company, shall be taken into account.

(2) *Special transitional rules.* (i) A loss from operations for any taxable year beginning before January 1, 1958, shall not be carried back to any taxable year beginning before January 1, 1955. Furthermore, a loss from operations for any taxable year beginning after December 31, 1957, shall not be carried back to any taxable year beginning before January 1, 1958.

(ii) If for any taxable year a life insurance company has made an election under section 810(e) (relating to certain decreases in reserves for voluntary employees' beneficiary associations) which is effective for such taxable year, the provisions of section 812(b)(1) and subparagraph (1) of this paragraph shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(3) *Illustration of principles.* The provisions of section 812(b)(1) and of this paragraph may be illustrated by the following examples:

Example 1. P, a life insurance company, organized in 1940, has a loss from operations of $1,000 in 1958. This loss cannot be carried back, but shall be carried forward to each of the 5 taxable years following 1958.

Example 2. Q, a life insurance company, organized in 1940, has a loss from operations of $1,200 in 1959. This loss shall be carried back to the taxable year 1958 and then shall be carried forward to each of the 5 taxable years following 1959.

Example 3. R, a life insurance company, organized in 1940, has a loss from operations of $1,300 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then shall be carried forward to each of the 5 taxable years following 1956. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied to such taxable years.

Example 4. S, a life insurance company, organized in 1958 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,400 for the taxable year 1958. This loss cannot be carried back, but shall be carried forward to each of the 8 taxable years following 1958, provided, however, S is not a nonqualified corporation at any time during the loss year (1958) or any taxable year thereafter.

Example 5. T, a life insurance company, organized in 1954 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,500 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then carried forward to each of the 8 taxable years following 1956, provided, however, T is not a nonqualified corporation at any time during the loss year (1956) or any taxable year thereafter. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I of subchapter L (as in effect for 1958) applied to such taxable years.

(4) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 812 the first, second, etc., preceding or succeeding taxable year. For the determination of the loss from operations for periods of less than 12 months, see section 818(d) and the regulations thereunder.

(5) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the loss from operations to the extent it was not absorbed in the computation of gain from operations for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the gain from operations for any such preceding taxable year, the various operations loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of

the gain from operations in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(6) *Corporate acquisitions.* For the computation of the operations loss carryovers in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

(b) *Portion of loss from operations which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) A loss from operations shall first be carried back to the earliest taxable year permissible under section 812(b) and paragraph (a) of this section for which such loss is allowable as a carryback or a carryover. The entire amount of the loss from operation shall be carried back to such earliest year.

(ii) Section 812(b)(2) provides that the portion of the loss from operations which shall be carried to each of the taxable years subsequent to the earliest taxable year shall be the excess (if any) of the amount of the loss from operations over the sum of the offsets (as defined in section 812(d) and paragraph (a) of §1.812–5) for all prior taxable years to which the loss from operations may be carried.

(2) *Illustration of principles.* The application of this paragraph may be illustrated by the following example:

Example. T, a life insurance company (which is not a new company as defined in section 812(e)(1)), has a loss from operations for 1960. The entire amount of the loss from operations for 1960 shall first be carried back to 1958. The amount of the carryback to 1959 is the excess (if any) of the 1960 loss over the offset for 1958. The amount of the carryover to 1961 is the excess (if any) of the 1960 loss over the sum of the offsets for 1958 and 1959. The amount of the 1960 loss remaining (if any) to be carried over to 1962, 1963, or 1964 shall be computed in a like manner.

[T.D. 6535, 26 FR 537, Jan. 20, 1961]

§ 1.812–5 Offset.

(a) *Offset defined.* Section 812(d) defines the term ''offset'' for purposes of section 812(b)(2) and paragraph (b)(1)(ii) of §1.812–4. For any taxable year the offset is only that portion of the increase in the operations loss deduction for the taxable year which is necessary to reduce the life insurance company taxable income (computed without regard to section 802(b)(3)) for such year to zero. For purposes of the preceding sentence, the offset shall be determined with the modifications prescribed in paragraph (b) of this section. Such modifications shall be made independently of, and without reference to, the modifications required by paragraph (a) of §1.812–3 for purposes of computing the loss from operations itself.

(b) *Modifications*—(1) *Operations loss deduction*—(i) *In general.* Section 812(d)(2) provides that for purposes of section 812(d)(1) (relating to the definition of offset), the operations loss deduction for any taxable year shall be computed by taking into account only such losses from operations otherwise allowable as carryovers or as carrybacks to such taxable year as were sustained in taxable years preceding the taxable year in which the life insurance company sustained the loss from operations from which the offset is to be deducted. Thus, for such purposes the loss from operations for the loss year or for any taxable year thereafter shall not be taken into account.

(ii) *Illustration of principles.* The provisions of this subparagraph may be illustrated by the following example:

Example. In computing the operations loss deduction for 1960, Y, a life insurance company, has a carryover from 1958 of $9,000, a carryover from 1959 of $6,000, a carryback from 1961 of $18,000, and a carryback from 1962 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the operations loss deduction for 1960, for purposes of determining the tax liability for 1960, is $43,000. However, in computing the offset for 1960 which is subtracted from the loss from operations for 1961 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the operations loss deduction for 1960 is $15,000, that is, the aggregate of the $9,000 carryover from 1958 and the $6,000 carryover from 1959. In computing the operations loss deduction for such purpose, the $18,000 carryback from 1961 and the $10,000 carryback from 1962 are disregarded. In computing the offset for 1960, however, which is subtracted from the loss from operations for 1962 for the purpose of determining the portion of such 1962 loss which may be carried over for subsequent taxable years, the operations loss deduction for 1960 is $33,000, that is, the aggregate of the $9,000 carryover from 1958, the $6,000 carryover from 1959, and the $18,000 carryback from 1961. In computing the operations loss deduction for such purpose, the $10,000 carryback from 1962 is disregarded.

(2) *Recomputation of deductions limited by section 809(f)*—(i) *In general.* If in any taxable year a life insurance company has deductions under section 809(d) (3), (5), and (6), as limited by section 809(f), and sustains a loss from operations in a succeeding taxable year which may be carried back as an operations loss deduction, such limitation and deductions shall be recomputed. This recomputation is required since the carryback must be taken into account for purposes of determining such limitation and deductions.

(ii) *Illustration of principles.* The provisions of this subparagraph may be illustrated by the following example:

(a) Facts. The books of P, a life insurance company, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1959	$9,000,000	$10,000,000	
1960			($9,800,000)

The gain from operations thus shown is computed without regard to any operations loss deduction or deductions under section 809(d) (3), (5), and (6), as limited by section 809(f). Assume that for the taxable year 1959, P has (without regard to the limitation of section 809(f) or the operations loss deduction for 1959) a deduction under section 809(d)(3) of $2,500,000 for dividends to policyholders and no deductions under section 809(d) (5) or (6).

(*b*) *Determination of section 809(f) limitation and deduction for dividends to policyholders without regard to the operations loss deduction for 1959.* In order to determine gain or loss from operations for 1959, P must determine the deduction for dividends to policyholders for such year. Under the provisions of section 809(f), the amount of such deduction shall not exceed the sum of *(1)* the amount (if any) by which the gain from operations for such year (determined without regard to such deduction) exceeds P's taxable investment income for such year, plus *(2)* $250,000. Since the gain from operations as thus determined ($10,000,000) exceeds the taxable investment income ($9,000,000) by $1,000,000, the limitation on such deduction is $1,250,000 ($1,000,000 plus $250,000). Accordingly, only $1,250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year is $8,750,000 ($10,000,000 minus $1,250,000).

(c) Recomputation of section 809(f) limitation and deduction for dividends to policyholders after application of the operations loss deduction for 1959. Since P has sustained a loss from operations for 1960 which shall be carried back to 1959 as an operations loss deduction, it must recompute the section 809(f) limitation and deduction for dividends to policyholders. Taking into account the $9,800,000 operations loss deduction for 1959 reduces gain from operations for such year to $200,000 ($10,000,000 minus $9,800,000). Since the gain from operations as thus determined ($200,000) is less than the taxable investment income ($9,000,000), the limitation on the deduction for dividends to policyholders is $250,000. Thus, only $250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year as thus determined is $9,750,000 ($10,000,000 minus $250,000) since for purposes of this determination the operations loss deduction for 1959 is not taken into account (see section 812(c)(1)). Accordingly, the offset for 1959 is $9,750,000 (the increase in the operations loss deduction for 1959, computed without regard to the carryback for 1960, which reduces life insurance company taxable income for 1959 to zero); thus, the portion of the 1960 loss from operations which shall be carried forward to 1961 is $50,000 (the excess of the 1960 loss ($9,800,000) over the offset for 1959 ($9,750,000)).

(3) *Minimum limitation.* The life insurance company taxable income, as modified under this paragraph, shall in no case be considered less than zero.

[T.D. 6535, 26 FR 537, Jan. 20, 1961]

§ 1.812–6 New company defined.

Section 812(e) provides that for purposes of part I, subchapter L, chapter 1 of the Code, a life insurance company is a ''new company'' for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or any predecessor if section 381(c)(22) applies or would have applied if in effect) was authorized to do business as an insurance company.

[T.D. 7326, 39 FR 35354, Oct. 1, 1974]

§ 1.812–7 Application of subtitle A and subtitle F.

Section 812(f) provides that except as modified by section 809(e) (relating to modifications of deduction items otherwise allowable under subtitle A of the Code) subtitles A and F of the Code shall apply to operations loss carrybacks and carryovers, and to the operations loss deduction, in the same manner and to the same extent that such subtitles apply in respect of net operation loss carrybacks, net operating loss carryovers, and the net operating loss deduction of corporations generally. For the computation of the operations loss carrybacks and carryovers, and of the operations loss deduction in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

[T.D. 6535, 26 FR 539, Jan. 20, 1961]

§ 1.812–8 Illustration of operations loss carrybacks and carryovers.

The application of § 1.812–4 may be illustrated by the following example:

(a) Facts. The books of M, a life insurance company, organized in 1940, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1958	$11,000	$15,000	
1959	23,000	30,000	
1960			($75,000)
1961	25,000	20,000	
1962			(150,000)
1963	22,000	30,000	
1964	40,000	35,000	
1965	62,000	75,000	
1966	25,000	17,000	
1967	39,000	53,000	

The gain from operations thus shown is computed without regard to any operations loss deduction. The assumption is also made that none of the other modifications prescribed in paragraph (b) of § 1.812–5 apply. There are no losses from operations for 1955, 1956, 1957, 1968, 1969, 1970.

(b) *Loss sustained in 1960.* The portions of the $75,000 loss from operations for 1960 which shall be used as carrybacks to 1958 and 1959 and as carryovers to 1961, 1962, 1963, 1964, and 1965 are computed as follows:

(1) *Carryback to 1958.* The carryback to this year is $75,000, that is, the amount of the loss from operations.

(2) *Carryback to 1959.* The carryback to this year is $60,000 (the excess of the loss for 1960 over the offset for 1958), computed as follows:

Loss from operations	$75,000
Less:	
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	15,000
Carryback	60,000

(3) *Carryover to 1961.* The carryover to this year is $30,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958 and 1959), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Sum of offsets		45,000
Carryover		30,000

(4) *Carryover to 1962.* The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, and 1961), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	80,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Sum of offsets		65,000
Carryover		10,000

(5) *Carryover to 1963.* The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, 1961, and 1962), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	

Offset for 1962 (a year in which a loss from operations was sustained)	0	
Sum of offsets		65,000
Carryover		10,000

(6) *Carryover to 1964.* The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, and 1963), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	30,000	
Sum of offsets		95,000
Carryover		0

(7) *Carryover to 1965.* The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, 1963, and 1964), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction for the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryover from 1962)	30,000	
Offset for 1964 (the $35,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	35,000	
Sum of offsets		130,000
Carryover		0

(c) *Loss sustained in 1962.* The portions of the $150,000 loss from operations for 1962 which shall be used as carrybacks to 1959, 1960, and 1961 and as carryovers to 1963, 1964, 1965, 1966, and 1967 are computed as follows:

(1) *Carryback to 1959.* The carryback to this year is $150,000, that is, the amount of the loss from operations.

(2) *Carryback to 1960.* The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the offset for 1959), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0
Carryback	150,000

(3) *Carryback to 1961.* The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959 and 1960), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0
Offset for 1960 (a year in which a loss from operations was sustained)	0
Sum of offsets	0
Carryback	150,000

(4) *Carryover to 1963.* The carryover to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, and 1961), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	

Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Sum of offsets		0
Carryover		150,000

(5) *Carryover to 1964.* The carryover to this year is $130,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, and 1963), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Sum of offsets		20,000
Carryover		130,000

(6) *Carryover to 1965.* The carryover to this year is $95,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, and 1964), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960 the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	
Sum of offsets		55,000
Carryover		95,000

(7) *Carryover to 1966.* The carryover to this year is $20,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, and 1965), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover for such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	

Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 to 1960, the carryover from 1962 to 1965 not being taken into account)	$75,000	
Sum of offsets		$130,000
Carryover		20,000

(8) *Carryover to 1967.* The carryover to this year is $3,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, 1965, and 1966), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	
Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1965 not being taken into account)	75,000	
Offset for 1966 (the $17,000 gain from operations for such year computed without the deduction of the carryover from 1962)	17,000	
Sum of offsets		147,000
Carryover		3,000

(d) *Determination of operations loss deduction for each year.* The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the operations loss deduction in the following manner:

Taxable year	Carryover		Carryback		Operations loss deductions
	From 1960	From 1962	From 1960	From 1962	
1958			$75,000		$75,000
1959			60,000	$150,000	210,000
1961	$30,000			150,000	180,000
1963	10,000	$150,000			160,000
1964		130,000			130,000
1965		95,000			95,000
1966		20,000			20,000
1967		3,000			3,000

[T.D. 6535, 26 FR 539, Jan. 20, 1961]

§ 1.812–9 Cross-reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and § 1.817A–1(a)(1)), *see* § 1.817A–1.

[T.D. 9058, 68 FR 24350, May 7, 2003]

DISTRIBUTIONS TO SHAREHOLDERS

§ 1.815–1 Taxable years affected.

Sections 1.815–2 through 1.815–6, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), the Act of October 10, 1962 (76 Stat. 808), and the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.815–2 Distributions to shareholders.

(a) *In general.* Section 815 provides that every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain two special surplus accounts for Federal income tax purposes. These special accounts are the shareholders surplus account (as defined in section 815(b) and § 1.815–3) and the policyholders surplus account (as defined in section 815(c) and § 1.815–4). To the extent that a distribution to shareholders (as defined in paragraph (c) of this section) is treated as being made out of the shareholders surplus account, no tax is imposed on the company with respect to such distribution. However, to the extent that a distribution to shareholders is treated as being made out of the policyholders surplus account, the amount subtracted from the policyholders surplus account by reason of such distribution shall be taken into account in determining life insurance company taxable income under section 802(b).

(b) *Priority system for distributions to shareholders.* (1) For purposes of section 815 (other than subsection (e) thereof relating to certain mutualizations) and section 802(b)(3) (relating to the determination of life insurance company taxable income), any distribution made to shareholders after December 31, 1958, shall be treated in the following manner:

(i) Distributions shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815–3);

(ii) Once the shareholders surplus account has been reduced to zero, distributions shall then be treated as being made out of the policyholders surplus account (as defined in section 815(c) and § 1.815–4) until that account has been reduced to zero; and

(iii) Finally, any distributions in excess of the amounts in the shareholders surplus account and the policyholders surplus account shall be treated as being made out of other accounts (as defined in § 1.815–5).

(2) For purposes of subparagraph (1) of this paragraph, in order to determine whether a distribution (or any portion thereof) shall be treated as being made out of the shareholders surplus account, policyholders surplus account, or other accounts, the amount in such accounts at the end of any taxable year shall be the cumulative balance in such accounts at the end of the taxable year, computed without diminution by reason of a distribution (or any portion thereof) during the taxable year which is treated as being made out of such accounts. For example, on January 1, 1960, S, a stock life insurance company, had $1,000 in its shareholders surplus account and $3,000 in its policyholders surplus account. On November 1, 1960, S distributed $4,000 to its shareholders. Under the provisions of section 815(b)(2) and paragraph (b) of § 1.815–3, S added $5,000 to its shareholders surplus account for the taxable year 1960. Since the distributions to shareholders during the taxable year 1960, $4,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions treated as made out of such account during the taxable year, $6,000 ($1,000 plus $5,000), the entire distribution is treated as being made out of the shareholders surplus account.

(3) Except in the case of a distribution in cash and as otherwise provided herein, the amount to be charged to the special surplus accounts referred to in subparagraph (1) of this paragraph with respect to any distributions to shareholders (as defined in section 815(a) and paragraph (c) of this section) shall be the fair market value of the property distributed, determined as of the date of distribution. However, for the amount of the adjustment to earnings and profits reflecting such distributions, see section 312 and the regulations thereunder. For a special rule relating to the determination of the amount to be charged to such special surplus accounts in the case of a distribution by a foreign life insurance company carrying on a life insurance business within the United States, see section 819(c)(1) and the regulations thereunder.

(c) *Distributions to shareholders defined.* (1) Except as otherwise provided in section 815(f) and subparagraph (2) of this paragraph, the term *distribution*, as used in section 815(a) and paragraph (b) of this section, means any distribution of property made by a life insurance company to its shareholders. For purposes of the preceding sentence, the term *property* means any property (including money, securities, and indebtedness to the company) other than stock, or rights to acquire stock, in the company making the distribution. Thus, for example, the term includes a distribution which is considered a dividend under section 316, but is not limited to the extent that such distribution must be made out of the accumulated or current earnings and profits of the company making the distribution. For example, except as otherwise provided in section 815(f) and subparagraph (2) of this paragraph, there is a distribution within the meaning of this paragraph in any case in which a corporation acquires the stock of a shareholder in exchange for property in a redemption treated as a distribution in exchange for stock under section 302(a) or treated as a distribution of property under section 302(d). For special rules relating to distributions to shareholders in acquisition of stock pursuant to a plan of mutualization, see section 815(e) and paragraph (e) of § 1.815–6.

(2) The term *distribution*, as used in section 815(a) and paragraph (b) of this section, does not (except for purposes of section 815(a)(3) and (e)(2)(B)) include any distribution in redemption of stock issued prior to January 1, 1958, where such stock was at all times on and after the date of its issuance and on and before the date of its redemption limited as to the amount of dividends payable and was callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of its issue price plus the amount of contribution to surplus (if any) made by the original purchaser at the time of his purchase.

[T.D. 6535, 26 FR 542, Jan. 20, 1961, as amended by T.D. 7189, 37 FR 12793, June 29, 1972]

§ 1.815–3 Shareholders surplus account.

(a) *In general.* Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a shareholders surplus account. This account shall be established as of January 1, 1958, and the beginning or opening balance of the shareholders surplus account on that date shall be zero.

(b) *Additions to shareholders surplus account.* (1) The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1957, shall be the amount by which the sum of:

(i) The life insurance company taxable income (computed without regard to section 802(b)(3)),

(ii) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, reduced (in the case of a taxable year beginning after December 31, 1961) by the amount referred to in subdivision (i) of this subparagraph,

(iii) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)), the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B)), and the amount of interest excluded from gross income under section 103, and

(iv) The small business deduction provided by section 809(d)(10). Exceeds the taxes imposed for the taxable year by section 802(a), computed without regard to section 802(b)(3).

(c) *Subtractions from shareholders surplus account*—(1) *In general.* There shall be subtracted from the cumulative balance in the shareholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, the amount which is treated as being distributed out of such account under section 815(a) and paragraph (b) of § 1.815–2.

(2) *Special rule; distributions in 1958.* There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of the distributions to shareholders made by the company during 1958. For example, assume S, a stock life insurance company, had additions to its shareholders surplus account (as determined under section 815(b)(2) and paragraph (b) of this section) for the taxable year 1958 of $10,000, and actually distributed as

dividends to its shareholders $8,000 during the year 1958. The balance in S's shareholders surplus account as of January 1, 1959, shall be $2,000. If S had distributed $12,000 as dividends in 1958, the balance in its shareholders surplus account as of January 1, 1959, would be zero and the other accounts referred to in section 815(a)(3) and paragraph (b)(1)(iii) of § 1.815–2 would be reduced by $2,000.

(d) *Illustration of principles.* The application of section 815(b) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960.

Balance in shareholders surplus account as of 1–1–60	$5,000
Life insurance company taxable income computed without regard to sec. 802(b)(3)	4,000
Excess of net long-term capital gain over net short-term capital loss	1,700
Tax-exempt interest included in gross investment income under sec. 804(b)	100
Small business deduction (determined under sec. 809(d)(10))	200
Tax liability under sec. 802(a) (1) and (2) computed without regard to sec. 802(b)(3)	1,625
Amount distributed to shareholders	9,000

For purposes of determining the amount to be subtracted from its shareholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in shareholders surplus account as of 1–1–60		$5,000
(2) Additions to account:		
(a) Life insurance company taxable income computed without regard to sec. 802(b)(3)	$4,000	
(b) Excess of net long-term capital gain over net short-term capital loss	1,700	
(c) Tax-exempt interest included in gross investment income under sec. 804(b)	100	
(d) Small business deduction (determined under sec. 809(d)(10))	200	
Total	6,000	
Less:		
Tax liability under sec. 802(a) (1) and (2) computed without regard to sec. 802(b)(3)	1,625	
		4,375
(3) Cumulative balance in shareholders surplus account as of 12–31–60 (item (1) plus item (2))		9,375

Since the amount distributed to shareholders during the taxable year, $9,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year, $9,375, under the provisions of section 815(a), the entire distribution shall be treated as being made out of the shareholders surplus account. Thus, $9,000 shall be subtracted from the shareholders surplus account (leaving a balance of $375 in such account at the end of the taxable year) and S shall incur no additional tax liability by reason of the distribution to its shareholders during the taxable year 1960.

[T.D. 6535, 26 FR 542, Jan. 20, 1961, as amended by T.D. 7189, 37 FR 12793, June 29, 1972]

§ 1.815–4 Policyholders surplus account.

(a) *In general.* Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a policyholders surplus account. This account shall be established as of January 1, 1959, and the beginning or opening balance of the policyholders surplus account on that date shall be zero.

(b) *Additions to policyholders surplus account.* The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of:

(1) An amount equal to 50 percent of the amount by which the gain from operations for the taxable year exceeds the taxable investment income,

(2) The deduction allowed or allowable under section 809(d)(5) (as limited by section 809(f)) for certain nonparticipating contracts, and

(3) The deduction allowed or allowable under section 809(d)(6) (as limited by section 809(f)) for taxable years beginning before January 1, 1963, for group life and group accident and health insurance contracts, and for taxable years beginning after December 31, 1962, for accident and health insurance and group life insurance contracts.

(c) *Subtractions from policyholders surplus account*—(1) *In general.* There shall be subtracted from the cumulative balance in the policyholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, an amount equal to the sum of:

(i) The amount which (without regard to subdivision (ii) of this subparagraph) is treated under section 815(a) as distributed out of the policyholders surplus account for the taxable year, plus

(ii) The amount (determined without regard to section 802(a)(3)) by which the tax imposed for taxable years beginning before January 1, 1962, by section 802(a)(1), and for taxable years beginning after December 31, 1961, by section 802(a), is increased by reason of section 802(b)(3).

In addition, there shall be subtracted from the policyholders surplus account for the taxable year those amounts which, at the close of the taxable year, are subtracted or treated as subtracted from the policyholders surplus account under section 815(d) (1) and (4) and paragraphs (a) and (d) of § 1.815–6. For purposes of this paragraph, the subtractions from the policyholders surplus account shall be treated as made in the following order:

(a) First the amount determined under section 815(c)(3) by reason of distributions to shareholders during the taxable year which are treated as being made out of the policyholders surplus account;

(b) Next the amount elected to be subtracted from the policyholders surplus account for the taxable year under section 815(d)(1);

(c) Then the amount which is treated as a subtraction from the policyholders surplus account for the taxable year by reason of the limitation provided in section 815(d)(4); and

(d) Finally the amount taken into account upon termination as a life insurance company as provided in section 815(d)(2).

(2) *Method of computing amount subtracted from policyholders surplus account*—(i) *Where life insurance company taxable income, computed without regard to section 802(b)(3), exceeds $25,000.* If the life insurance company taxable income for any taxable year computed under section 802(b), computed without regard to section 802(b)(3), exceeds $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate for the taxable year.

(ii) *Where life insurance company taxable income does not exceed $25,000.* If the life insurance company taxable income for any taxable year, computed under section 802(b), does not exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the normal tax rate for the taxable year.

(iii) *Where life insurance company taxable income, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000.* If the life insurance company taxable income for any taxable year, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined in the following manner:

(a) First, determine the amount by which $25,000 exceeds the amount determined under section 802(b) (1) and (2);

(b) Then, multiply the amount determined under *(a)* by a ratio, the numerator of which is 100 percent minus the normal tax rate and the denominator of which is 100 percent;

(c) Next, determine the amount by which the amount treated as distributed out of the policyholders surplus account exceeds the amount determined under *(b)* and multiply such excess by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate; and

(d) Finally, add the amounts determined under *(a)* and *(c)*.

(3) *Illustration of principles.* The application of section 815(c)(3) and subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. The life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000 for the taxable year 1959. Assume that of the amount distributed by S to its shareholders during the taxable year, $9,600 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the sum of the normal tax rate (30%) and the surtax rate (22%) in effect for 1959 is 52 percent. S shall subtract $20,000 from its policyholders surplus account for the taxable year 1959, computed as follows:

$$\$9{,}600\times100/(100-52)=\$9{,}600\times100/48=\$20{,}000$$

Of this amount, $9,600 is due to the application of section 815(c)(3)(A) and $10,400 to the application of section 815(c)(3)(B).

Example 2. Assume that for the taxable year 1960, S, a stock life insurance company, has taxable investment income of $1,000 and a gain from operations of $2,000. Assume further that of the amount distributed by S to its shareholders during the taxable year, $3,500 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since S's life insurance company taxable income does not exceed $25,000 for the taxable year and the normal tax rate in effect for 1960 is 30 percent, S shall subtract $5,000 from its policyholders surplus account for the taxable year 1960, computed as follows:

$$\$3{,}500\times100/(100-30)=\$3{,}500\times100/70=\$5{,}000$$

Of this amount, $3,500 is due to the application of section 815(c)(3)(A), and $1,500 to the application of section 815(c)(3)(B).

Example 3. For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), is $10,000. Assume that of the amount distributed by S to its shareholders during the taxable year, $12,000 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the life insurance company taxable income of S, computed with regard to section 802(b)(3), exceeds $25,000, in order to determine the amount to be subtracted from its policyholders surplus account, S would make up the following schedule:

(1) $25,000 minus life insurance company taxable income, computed without regard to sec. 802(b)(3) ($25,000 minus $10,000	$15,000
(2) Item (1) multiplied by 100 percent minus the normal tax rate as in effect for 1960, over 100 percent ($15,000×(100−30)÷100)	10,500
(3) Amount by which the amount treated as distributed out of policyholders surplus account ($12,000) exceeds item (2) ($10,500), multiplied by 100 percent over 100 percent minus the sum of the normal tax rate and the surtax rate as in effect for 1960 ($1,500×100÷(100−52))	3,125
(4) Item (1) plus item (3) ($15,000 plus $3,125)	18,125

For the taxable year 1960, S shall subtract $18,125 from its policyholders surplus account. Of this amount, $10,500 represents the distribution from the policyholders surplus account which is taxed at a 30 percent tax rate and $1,500 the distribution from the policyholders surplus account which is taxed at a 52 percent tax rate. Thus, of the amount subtracted from the policyholders surplus account for the taxable year 1960, $12,000 is due to the application of section 815(c)(3) (A), and $6,125 to the application of section 815(c)(3)(B).

(d) *Illustration of principles.* The application of section 815(c) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Taxable investment income	$25,000
Gain from operations	30,000
Tax base (sec. 802(b)(1) and (2))	27,500
Deduction for certain nonparticipating policies provided by sec. 809(d)(5) (as limited by sec. 809(f))	600
Deduction for group policies provided by sec. 809(d)(6) (as limited by sec. 809(f))	400
Amount distributed to shareholders	60,000
Cumulative balance in shareholders surplus account as of 12–31–60	36,000
Balance in policyholders surplus account as of 1–1–60	48,000

For purposes of determining the amount to be subtracted from its policyholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the policyholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in policyholders surplus account as of 1–1–60		$48,000
(2) Additions to account:		
(a) 50 percent of the amount by which the gain from operations ($30,000) exceeds the taxable investment income ($25,000) (1/2 ×$5,000)	$2,500	
(b) The deduction for certain nonparticipating contracts provided by sec. 809(d)(5) (as limited by sec. 809(f))	600	
(c) The deduction for group contracts provided by sec. 809(d)(6) (as limited by sec. 809(f))	400	

	3,500
(3) Cumulative balance in policyholders account as of 12–31–60 (item (1) plus item (2))	51,500

Under the provisions of section 815(a), since the amount distributed to shareholders during the taxable year, $60,000, exceeds the cumulative balance in the shareholders surplus at the end of the taxable year, computed without diminution by reason of distributions during the taxable year, $36,000, the shareholders surplus account shall first be reduced to zero. The remaining $24,000 ($60,000 minus $36,000) of the distribution shall then be treated as made out of the policyholders surplus account. Thus, since the tax base under section 802(b)(1) and (2) is in excess of $25,000, the total amount to be subtracted from the policyholders surplus account at the end of the taxable year would be $50,000 ($24,000×100÷(100−52)). Of this amount $26,000 ($50,000 minus $24,000) represents the tax on the portion of the distribution to shareholders which is treated as being out of the policyholders surplus account.

(e) *Special rule for 1959 and 1960.* For a special transitional rule applicable to any increase in tax liability under section 802(b)(3) for the taxable years 1959 and 1960 which is due solely to the operation of section 815(c)(3) and this section, see section 802(a)(3) and § 1.802–5.

[T.D. 6535, 26 FR 543, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.815–5 Other accounts defined.

The term *other accounts,* as used in section 815(a)(3) and paragraph (b) of § 1.815–2, means all amounts which are not specifically included in the shareholders surplus account under section 815(b) and paragraph (b) of § 1.815–3, or in the policyholders surplus account under section 815(c) and paragraph (b) of § 1.815–4. Thus, for example, other accounts includes amounts representing the increase in tax due to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the special transitional rule provided in section 802(a)(3) and § 1.802–5, earnings and profits accumulated prior to January 1, 1958, paid-in surplus, capital, etc. To the extent that a distribution (or any portion thereof) is treated as being made out of other accounts, no tax is imposed on the company with respect to such distribution.

[T.D. 6535, 26 FR 544, Jan. 20, 1961]

§ 1.815–6 Special rules.

(a) *Election to transfer amounts from policyholders surplus account to shareholders surplus account*—(1) *In general.* Section 815(d)(1) permits a life insurance company to elect, after the close of any taxable year for which it is a life insurance company, to subtract any amount (or any portion thereof) in its policyholders surplus account as of the close of the taxable year. The effect of such election is to subject the company to tax on the amounts elected to be subtracted for the taxable year for which the election applies. The amount so subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the taxable year following the taxable year for which the election applies and no further tax shall be imposed upon the company if the amount elected to be transferred to the shareholders surplus account is subsequently distributed to shareholders.

(2) *Manner and effect of election.* (i) The election provided by section 815(d)(1) and this section shall be made in a statement attached to the life insurance company's income tax return for any taxable year for which the company desires the election to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. In addition, the statement shall indicate that the company has made the election provided under section 815(d)(1) for the taxable year and the amount elected to be subtracted from the policyholders surplus account.

(ii) An election made under section 815(d)(1)(B) and subdivision (i) of this subparagraph shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which it desires the election to apply. Once such an election has been made for any taxable year it may not be revoked.

(3) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000. Assume that S elects to subtract $20,000 from its policyholders surplus account under section 815(d)(1) for the taxable year. Since S is subject to a 52 percent tax rate, the tax on the amount elected to be subtracted from the policyholders surplus account (as of the close of the taxable year 1960) is $10,400 ($20,000×52 percent). Thus, the amount to be added to the shareholders surplus account as of January 1, 1961, is $9,600 (the amount subtracted from the policyholders surplus account by virtue of the section 815(d)(1) election, less the tax imposed upon such amount by reason of section 802(b)(3), or $20,000 minus $10,400).

(b) *Termination as life insurance company*—(1) *Effect of termination.* Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), section 815(d)(2)(A) provides that if for any taxable year the taxpayer is not an insurance company (as defined in paragraph (a) of §1.801–3), or if for any two successive taxable years the taxpayer is not a life insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3), the amount taken into account under section 802(b)(3) for the last preceding year for which the company was a life insurance company shall be increased (after the application of section 815(d)(2)(B)) by the entire balance in the policyholders surplus account at the close of such last preceding taxable year.

(2) *Effect of certain distributions.* If for any taxable year the taxpayer is an insurance company (as defined in paragraph (a) of §1.801–3) but is not a life insurance company (as defined in section 801(a) and paragraph (b) of §1.801–3), section 815(d)(2)(B) provides that any distribution to shareholders during such taxable year shall be treated as having been made on the last day of the last preceding taxable year for which the company was a life insurance company.

(3) *Examples.* The application of section 815(d)(2) and this paragraph may be illustrated by the following examples:

Example 1. At the end of the taxable year 1959, the balance in the policyholders surplus account of S, a life insurance company within the meaning of section 801(a) and paragraph (b) of §1.801–3, is $12,000. If S fails to qualify as an insurance company (as defined in paragraph (a) of §1.801–3) for the taxable year 1960, and section 381(c)(22) does not apply, under the provisions of section 815(d)(2)(A), the entire balance of $12,000 in the policyholders surplus account at the end of 1959, the last year S was a life insurance company, shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

Example 2. Assume the facts are the same as in example 1, except that for the taxable years 1960 and 1961, S qualifies as an insurance company (as defined in paragraph (a) of §1.801–3) but does not qualify as a life insurance company within the meaning of section 801(a) and paragraph (b) of §1.801–3. Assume further that as a result of a distribution by S to its shareholders in 1960, $4,800 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Under the provisions of section 815(d)(2)(B), if section 381(c)(22) does not apply, any distribution to shareholders during the taxable years 1960 and 1961 shall be treated as having been made on December 31, 1959 (the last day of the last preceding taxable year for which S was a life insurance company). Thus, assuming S is subject to a 52 percent tax rate on additions to life insurance company taxable income, $10,000 ($4,800 plus $5,200, the tax on the portion of the distribution treated as made out of the policyholders surplus account) shall be treated as being subtracted from the policyholders surplus account at the end of 1959 and shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959. Under the provisions of section 815(d)(2)(A), the entire balance of $2,000 ($12,000 minus $10,000) in the policyholders surplus account at the end of 1959 (after the application of section 815(d)(2)(B)), shall also be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

(c) *Treatment of certain indebtedness.* Section 815(d)(3) provides that if a taxpayer makes any payment in discharge of its indebtedness and such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959, the amount of such payment shall be treated as a distribution in cash to shareholders both for purposes of section 802(b)(3) and section 815. However, this paragraph shall only apply to the extent that the distribution of such indebtedness to shareholders was treated as being out of accounts other than the shareholders and policyholders surplus accounts at the time of distribution.

(d) *Limitation on amount in policyholders surplus account*—(1) *In general.* Section 815(d)(4) provides a limitation on the amount that any life insurance company may accumulate in its policyholders surplus account. If the policyholders surplus account at the end of any taxable year (computed without regard to this paragraph) exceeds whichever of the following is the greatest:

(i) 15 percent of life insurance reserves (as defined in section 801(b) and paragraph (a) of § 1.801–4) at the end of the taxable year.

(ii) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or

(iii) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1),

then such excess shall be treated as a subtraction from the policyholders surplus account as of the end of such taxable year. The amount so treated as subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account at the beginning of the succeeding taxable year.

(2) *Example.* The application of the limitation contained in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Balance in policyholders surplus account, computed without regard to sec. 815(d)(4), as of 12–31–60	$175
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–60	4,500
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–58	3,900
Premiums and other consideration taken into account for the taxable year under sec. 809(c)(1)	310

In order to determine the limitations on the amount that it may accumulate in its policyholders surplus account at the end of the taxable year under section 815(d)(4), S would make up the following schedule:

(1) 15 percent of life insurance reserves at the end of the taxable year (15%×$4,500)	$675
(2) 25 percent of amount by which life insurance reserves at the end of the taxable year ($4,500) exceed life insurance reserves as of 12–31–58 ($3,900) (25%×$600)	150
(3) 50 percent of premiums and other consideration taken into account under sec. 809(c)(1) for the taxable year (50%×$310)	155
(4) Limitation on policyholders surplus account (the greatest of items (1), (2), or (3))	675

Since the balance in the policyholders surplus account at the end of the taxable year 1960, $175, does not exceed the limitation provided by section 815(d)(4), $675, S is not required to make any further adjustment to its policyholders surplus account at the end of the taxable year.

(e) *Special rule for certain mutualizations*—(1) *In general.* Section 815(e) provides a rule for determining priorities which shall operate in place of section 815(a) and paragraph (b) of § 1.815–2 where a life insurance company makes any distribution to its shareholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization. Section 815(e)(1) provides that such a distribution shall first be treated as being made out of paid-in capital and paid-in surplus, and, to the extent thereof, no tax shall be imposed on the company with respect to such distribution. Thereafter, distributions made pursuant to such plan of mutualization shall be treated as made in two allocable parts. One part shall be treated as being made out of other accounts (as defined in § 1.815–5) and the company shall incur no tax with respect to such portion of the distribution. The other part shall be treated as a distribution to which section 815(a) and paragraph (b) of § 1.815–2 applies. Thus, such portion of the distribution shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815–3), to the extent thereof, and then out of the policyholders surplus account (as defined in section 815(c) and § 1.815–4), to the extent thereof. See paragraph (a) of § 1.815–2. For purposes of this paragraph, a distribution shall be considered as being made pursuant to a plan of mutualization only if the requirements of applicable State law for the adoption of such plan (as, for example, approval by the requisite majority of the board of directors, shareholders, and policyholders) have been fulfilled.

(2) *Allocation ratio.* Section 815(e)(2)(A) provides an allocation ratio which when applied to the amount distributed under a plan of mutualization in excess of the balance in the paid-in capital and paid-in surplus accounts determines the portion of such excess to be treated as distributed out of the shareholders surplus account, policyholders surplus account, or other accounts. The numerator of this ratio is the excess of the assets of the company (as defined in section 805(b)(4) and paragraph (a)(4) of §1.805–5) over the total liabilities (including reserves), both determined as of December 31, 1958, and adjusted in the manner provided in subparagraph (3) of this paragraph. The denominator of this ratio is the amount included in the numerator plus the amounts in the shareholders surplus account and policyholders surplus account, all determined as of the beginning of the year of the distribution.

(3) *Adjustment for certain distributions.* Section 815(e)(2)(B) provides that if between 1958 and the year of distribution the taxpayer has been treated as having made a distribution (under a plan of mutualization or otherwise) which is treated as a return of paid-in capital and paid-in surplus or as out of other accounts (as defined in §1.815–5), the aggregate amount of any such prior distributions must be subtracted from the numerator and denominator in all cases where the allocation ratio provided by subparagraph (2) of this paragraph applies.

(f) *Recomputation required as a result of a subsequent loss from operations under section 812*—(1) *In general.* Any amounts added to or subtracted from the special surplus accounts referred to in section 815(a) and paragraph (b) of §1.815–2 for any taxable year shall be adjusted to the extent necessary to properly reflect a subsequent loss from operations which under section 812 is carried back to the taxable year for which such additions or subtractions were made.

(2) *Example.* The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that for the taxable years 1959 through 1961, the books of S, a stock life insurance company subject to a 30 percent tax rate for all taxable years involved, reflect the following items:

	1959	1960	1961
Taxable investment income	$40.00	$40.00	$40.00
Gain from operations	60.00	60.00	60.00
Tax base (sec. 802(b)(1) and (2))	50.00	50.00	50.00
Tax (sec. 802(b)(1) and (2) base)	15.00	15.00	15.00
Shareholders surplus account—			
At beginning of year	0	35.00	37.00
Added at beginning of year by reason of election under sec. 815(d)(1)	0	7.00	0
Added for year (without regard to election under sec. 815(d)(1))	35.00	35.00	35.00
Subtracted (distributions)	0	40.00	40.00
Policyholders surplus account—			
At beginning of year	0	0	10.00
Added for year	10.00	10.00	10.00
Subtracted (distributions)	0	0	0
Subtracted (by reason of election under sec. 815(d)(1))	10.00	0	0
Tax base (sec. 802(b)(3))	10.00	0	0
Tax (sec. 802(b)(3) base)	3.00	0	0

Assume further that S has a loss from operations for the taxable year 1962 of $25. Under the provisions of section 812, the $25 loss from operations would be carried back to the taxable year 1959 and would reduce the 1959 tax base under section 802(b)(1) and (2) to $35 ($60 minus $25). After adjustments reflecting the 1962 loss from operations, the results for the taxable years 1959 through the beginning of 1962 would be as follows:

	1959	1960	1961	1962
Taxable investment income	$40.00	$40.00	$40.00	....
Gain from operations	35.00	60.00	60.00	....
Tax base (sec. 802(b)(1) and (2))	35.00	50.00	50.00	....
Tax (sec. 802(b)(1) and (2) base)	10.50	15.00	15.00	....
Shareholders surplus account—				
At beginning of year	0	24.50	19.50	$14.50
Added for year (without regard to election under sec. 815(d)(1))	24.50	35.00	35.00	....

	1959	1960	1961	1962
Added by reason of election under sec. 815(d)(1)	0	0	0	....
Subtracted (distributions)	0	40.00	40.00	....
Policyholders surplus account—				
At beginning of year	0	0	10.00	20.00
Added for year	0	10.00	10.00	....
Subtracted (distributions)	0	0	0	....
Subtracted (by reason of election under sec. 815(d)(1))	0	0	0	....
Tax base (sec. 802(b)(3))	0	0	0	....
Tax (sec. 802(b)(3) base)	0	0	0	....

As a result of the loss from operations for 1962, the election under section 815(d)(1) for the taxable year 1959 has become inapplicable in its entirety since the balance in the policyholders surplus account at the end of 1959, as recomputed, is zero. Thus, S would be entitled to a total refund of $7.50 for the taxable year 1959. Of this amount, $4.50 is due to the recomputation of the section 802(b)(1) and (2) tax base and $3 to the amount of tax paid by reason of the election under section 815(d)(1).

[T.D. 6535, 26 FR 545, Jan. 20, 1961]

MISCELLANEOUS PROVISIONS

§ 1.817–1 Taxable years affected.

Except as otherwise provided therein, §§ 1.817–2 through 1.817–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 3 of the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.817–2 Treatment of capital gains and losses.

(a) *In general.* For taxable years beginning after December 31, 1958, and before January 1, 1962, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) prior to its amendment by section 3 of the Act of October 23, 1962 (76 Stat. 1134), imposes a separate tax equal to 25 percent of such excess. For taxable years beginning after December 31, 1961, if the net long-term capital gain of any life insurance company exceeds its net short-term capital loss, section 802(a)(2) imposes an alternative tax in lieu of the tax imposed by section 802(a)(1), if and only if such alternative tax is less than the tax imposed by section 802(a)(1). Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses, such as subchapter O (relating to gain or loss on disposition of property), subchapter P (relating to capital gains and losses), etc., shall apply with respect to life insurance companies.

(b) *Modification of section 1221 and 1231.* (1) In the case of a life insurance company, section 817(a)(1) provides that for purposes of applying section 1231(a) (relating to property used in the trade or business and involuntary conversions), the term *property used in the trade or business* shall be treated as including only:

(i) Property used in carrying on an insurance business, of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977), and real property used in carrying on an insurance business, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977), and which is not:

(a) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year;

(b) Property held by the taxpayer primarily for sale to customers in the ordinary course of business; or

(c) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by a taxpayer described in section 1221(3). In the case of a letter, memorandum, or property similar to a letter or memorandum, this subdivision *(c)* applies only to sales and other dispositions occurring after July 25, 1969.

(ii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(2) In the case of a life insurance company, section 817(a)(2) provides that for purposes of applying section 1221(2) (relating to the exclusion of certain property from the term capital asset), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

(3) Section 1231(a), as modified by section 817(a)(1) and subparagraph (1) of this paragraph, shall apply to recognized gains and losses from the following:

(i) The sale, exchange, or involuntary conversion of the following property, if held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977):

(a) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(b) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company; and

(c) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(ii) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977).

(iii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) Section 1221(2), as modified by section 817(a)(2) and subparagraph (2) of this paragraph, shall include only the following property;

(i) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(ii) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company; and

(iii) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(5) If an asset described in subparagraph (3) (i)(*a*), (*b*), or (*c*) or subparagraph (4) of this paragraph, or any portion thereof, is also an ''investment asset'' (an asset from which gross investment income, as defined in section 804(b), is derived), such asset, or portion thereof, shall not be treated as an asset used in carrying on an insurance business. Accordingly, the gains or losses from the sale or exchange (or considered as from the sale or exchange) of depreciable assets attributable to any trade or business, other than the insurance trade or business, carried on by the life insurance company, such as operating a radio station, housing development, or a farm, or renting various pieces of real estate shall be treated as gains or losses from the sale or exchange of a capital asset unless such asset is involuntarily converted (within the meaning of paragraph (e) of § 1.123–1).

(c) *Illustration of principles.* The provisions of section 817(a) and this section may be illustrated by the following examples:

Example 1. L, a life insurance company, has recognized gains and losses for the taxable year 1959 from the sale or involuntary conversion of the following items:

	Gains	*Losses*
Stocks, held for more than 6 months	$100,000	....
Bonds, held for more than 6 months	....	$5,000
Housing development, held for more than 6 months	....	400,000
Branch office building owned and occupied by L, held for more than 6 months	....	115,000
Furniture and equipment used in the investment department, held for more than 6 months	30,000	....
Radio station, held for more than 6 months	200,000	....
Involuntary conversion of apartment building, held for more than 6 months	7,000	....

The recognized gains and losses from the sale of the stocks, bonds, housing development, and radio station shall be treated as gains and losses from the sale of capital assets since such items are capital assets within the meaning of section 1221 (as modified by section 817(a)(2)). Accordingly, the provisions of section 1231 shall not apply to the sale of such capital assets. However, the provisions of section 1231 (as modified by section 817(a)(1)) shall apply to the sale of the branch office building and the furniture and equipment, and the apartment building involuntarily converted. Since the aggregate of the recognized losses ($115,000) exceeds the aggregate of the recognized gains ($37,000), the gains and losses are treated as ordinary gains and losses.

Example 2. Y, a life insurance company, owns a twenty-story home office building, having an adjusted basis of $15,000,000, ten floors of which it rents to various tenants, one floor of which is utilized by it in operating its investment department, and the remaining nine floors of which are occupied by it in carrying on its insurance business. If in 1960, Y sells the building for $10,000,000, Y must first apportion its basis between that portion of the building (one-half) used in carrying on an insurance business, and that portion of the building (one-half) classified as an ''investment asset'', before it can determine the character of the loss attributable to each portion of the building. For such purpose, the one floor utilized by Y in operating its investment department is treated as used in carrying on an insurance business. Assuming that each portion of the building bears an equal (one-half) relation to the basis of the entire building, Y (without regard to section 817(b)) would have a $2,500,000 ordinary loss on that portion used in carrying on an insurance business (assuming that Y had no gains subject to section 1231), and a $2,500,000 capital loss on that portion of the building classified as an investment asset.

[T.D. 6558, 26 FR 2782, Apr. 4, 1961, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 7369, 40 FR 29840, July 16, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.817–3 Gain on property held on December 31, 1958, and certain substituted property acquired after 1958.

(a) *Limitation on gain recognized on property held on December 31, 1958.* (1) Section 817(b)(1) limits the amount of gain that shall be recognized on the sale or other disposition of property other than insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property) if:

(i) The property was held (or treated as held within the meaning of paragraph (c)(1) of this section) by a life insurance company on December 31, 1958;

(ii) The taxpayer has been a life insurance company at all times on and after December 31, 1958, including the date of the sale or other disposition of the property; and

(iii) The fair market value of the property on December 31, 1958, exceeds the adjusted basis for determining gain as of such date.

The gain on the sale or other disposition of such property shall be limited to an amount (but not less than zero) equal to the amount by which the gain (determined without regard to section 817(b)(1)) exceeds the difference between fair market value of such property on December 31, 1958, and the adjusted basis for determining gain as of such date. Accordingly, the tax imposed under section 802(a) shall apply with respect to the amount of gain so limited. In addition, in the case of a stock life insurance company, the amount of such gain shall be taken into account under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to the shareholders surplus account (as defined in section 815(b) and § 1.815–3) for the taxable year. Furthermore, the amount of the gain (determined without regard to section 817(b)(1) and this paragraph) which is not taken into account under section 802(a) and under paragraph (f) of § 1.802–3 by reason of the application of section 817(b)(1) shall be included in other accounts (as defined in § 1.815–5) by such a company for the taxable year.

(2) Section 817(b)(1) and subparagraph (1) of this paragraph shall not apply for purposes of determining loss with respect to property held on December 31, 1958.

(b) *Illustration of principles.* The application of section 817(b)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example 1. On December 31, 1958, J, a stock life insurance company, owned stock of Z Corporation and on such date the stock had an adjusted basis for determining gain of $5,000 and a fair market value of $6,000. On August 1, 1959, the company sells such stock for $8,000. Assuming J qualifies as a life insurance company for the taxable year 1959, and applying the provisions of section 817(b)(1) and paragraph (a) of this section, the gain recognized (assuming no adjustment to basis for the period since December 31, 1958) on the sale shall be limited to $2,000 (the amount by which the gain realized, $3,000, exceeds the difference, $1,000, between the fair market value, $6,000, and the adjusted basis, $5,000, for determining gain on December 31, 1958). Thus, J shall take into account $2,000 under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to its shareholders surplus account for the taxable year and shall include $1,000 in other accounts for the taxable year.

Example 2. The facts are the same as in example 1, except that the selling price is $5,800. In such case, no gain shall be recognized even though there is a realized gain of $800 since such realized gain does not exceed the difference ($1,000) between the fair market value ($6,000) and the adjusted basis ($5,000) for determining gain on December 31, 1958. Furthermore, no loss shall be realized or recognized as a result of this transaction. Thus, J shall include $800 in other accounts for the taxable year and shall not take into account any amount under section 815(b)(2)(A)(ii).

Example 3. The facts are the same as in example 1, except that the adjusted basis for determining loss is $5,000 and the selling price is $4,500. In such case, since J has sustained a loss, section 817(b)(1) does not apply.

(c) *Certain substituted property acquired after December 31, 1958.* Section 817(b)(2) provides that if a life insurance company acquires property after December 31, 1958, in exchange for property actually held by the company on December 31, 1958, and the property acquired has a substituted basis within the meaning of section 1016(b) and § 1.1016–10, the following rules shall apply:

(1) For purposes of section 817(b)(1), such acquired property shall be deemed as having been held continuously by the taxpayer since the beginning of the holding period thereof as determined under section 1223;

(2) The fair market value and adjusted basis referred to in section 817(b)(1) shall be that of that property for which the holding period taken into account includes December 31, 1958;

(3) Section 817(b)(1) shall apply only if the property or properties, the holding periods of which are taken into account, were held only by life insurance companies after December 31, 1958, during the holding periods so taken into account;

(4) The difference between the fair market value and adjusted basis referred to in section 817(b)(1) shall be reduced (but not below zero) by the excess of (i) the gain that would have been recognized but for section 817(b) on all prior sales or other dispositions after December 31, 1958, of properties referred to in section 817(b)(2)(C) over (ii) the gain that was recognized on such sales or other dispositions; and

(5) The basis of such acquired property shall be determined as if the gain which would have been recognized but for section 817(b) were recognized gain.

For purposes of section 817(b)(2) and this paragraph, the term *property* does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property). Furthermore, the provisions of section 817(b)(1) and paragraph (a)(1) of this section shall not apply for purposes of determining loss with respect to property described in section 817(b)(2) and this paragraph.

(d) *Illustration of principles.* The application of section 817(b)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume that W, a life insurance company, owns property B on December 31, 1958, at which time its adjusted basis was $1,000 and its fair market value was $1,800. On January 31, 1960, in a transaction to which section 1031 (relating to exchange of property held for productive use or investment) applies, W receives property H having a fair market value of $1,700 plus $300 in cash in exchange for property B. The gain realized on the transaction, without regard to section 817(b) is $1,000 (assuming no adjustments to basis for the period since December 31, 1958). Under the provisions of section 817(b)(1) the gain is limited to $200. The entire $200 shall be recognized since such amount is less than the amount of gain ($300) which would be recognized under section 1031. Applying the provisions of section 817(b)(2) and paragraph (c) of this section, the basis of property H shall be determined as if the entire $300 of cash received is recognized gain. Thus, the basis of property H under section 1031 is $1,000 ($1,000 (the basis of property B) minus $300 (the amount of money received) plus $300 (the recognized gain of $200 plus $100 which would have been recognized but for section 817(b)). If W later sells property H for $2,200 cash, and assuming no further adjustments to its basis of $1,000, the gain realized is $1,200, but due to the application of section 817(b)(2) the amount of gain recognized is $500, computed as follows:

Selling price		$2,200
Less: Adjusted basis as of date of sale		1,000
Gain realized		1,200
Fair market value as of 12–31–58	$1,800	
Adjusted basis as of 12–31–58	1,000	
Excess of fair market value over adjusted basis	800	
Less: Excess of gain which would have been recognized on all prior dispositions but for sec. 817(b) over gain recognized on all prior dispositions ($300 minus $200)	100	
		$700
Gain recognized	500	

[T.D. 6558, 26 FR 2783, Apr. 4, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.817–4 Special rules.

(a) *Limitation on capital loss carryovers.* Section 817(c) provides that a net capital loss (as defined in section 1222(10)) for any taxable year beginning before January 1, 1959, shall not be taken into account. For any taxable year beginning after December 31, 1958, the provisions of part II, subchapter P, chapter 1 of the Code (relating to the treatment of capital losses) shall be applicable to life insurance companies for purposes of determining the tax imposed by section 802(a) and § 1.802–3 (relating to the imposition of tax in case of capital gains).

(b) *Gain on transactions occurring prior to January 1, 1959.* For purposes of part I, subchapter L, chapter 1 of the Code, section 817(d) provides that:

(1) There shall be excluded from tax any gain from the sale or exchange of a capital asset, and any gain considered as gain from sale or exchange of a capital asset, which results from sales or other dispositions of property prior to January 1, 1959; and

(2) Any gain after December 31, 1958, resulting from the sale or other disposition of property prior to January 1, 1959, which, but for this subparagraph would be taken into account under section 1231, shall not be taken into account under section 1231.

For example, if a life insurance company makes an installment sale of a capital asset prior to January 1, 1959, and payments are received after such date, any capital gain attributable to such sale shall not be taken into account for purposes of section 802(a). Furthermore, any gain referred to in subparagraphs (1) and (2) and the preceding sentence shall not be taken into account in determining the excess of the net short-term capital gain over the net long-term capital loss (and for taxable years beginning after December 31, 1961, the excess of the net long-term capital gain over the net short-term capital loss) for purposes of computing taxable investment income under section 804(a)(2) or gain or loss from operations under section 809(b).

(c) *Certain reinsurance transactions in 1958.* For purposes of part I, section 817(e) provides that where a life insurance company reinsures (or sells) all of its insurance contracts of a particular type, such as an entire industrial department, in either a single transaction, or in a series of related transactions, all of which occurred during 1958, and the reinsuring (or purchasing) company or companies assume all liabilities under such contracts, such reinsurance (or sale) shall be treated as the sale of a capital asset. However, such transaction shall be subject to the provisions of section 806(a) and § 1.806–3 (relating to adjustments for certain changes in reserves and assets).

(d) *Certain other reinsurance transactions.* (1) For any taxable year beginning after December 31, 1958, the reinsurance of all or a part of the insurance contracts of a particular type by a life insurance company, in either a single transaction, or in a series of related transactions, occurring in any such taxable year, whereby the reinsuring company or companies assume all liabilities under such contracts, shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of section 806(a) and 809 and the regulations thereunder. However, if in connection with a transaction described in the preceding sentence the reinsured or reinsurer transfers an asset which is a capital asset within the meaning of section 1221 (as modified by section 817(a)(2)), such transfer shall be treated as the sale or exchange of a capital asset by the transferor.

(2)(i) The consideration paid by the reinsured to the reinsurer in connection with a transaction described in subparagraph (1) of this paragraph shall be treated as an item of deduction under section 809(d)(7). However any amount received by the reinsured from the reinsurer shall be applied against and reduce (but not below zero) the amount of such consideration, and to the extent that it exceeds such consideration, shall be treated as an item of gross amount under section 809(c)(3).

(ii) In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of §1.809–5) transaction, a reinsurer shall in any taxable year beginning after December 31, 1957:

(A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and

(B) Treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

(iii) For purposes of paragraph (d)(2)(ii) of this section where the reinsured transfers to the reinsurer in connection with the assumption reinsurance transaction a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer shall be treated as:

(A) Having received from the reinsured consideration in an amount equal to the net amount of the increase in the reinsurer's reserves resulting from the transaction, and

(B) Having paid the reinsured an amount for the purchase of the contracts equal to the excess of the amount of such increase in the reinsurer's reserves over the net amount received from the reinsured.

(iv) For purposes of this subparagraph, the term *reasonably estimated life* means the period during which the contract reinsured remains in force. Such period shall be based on the facts in each case (such as age, health, and sex of the insured, type of contract reinsured, etc.) and the assuming company's experience (such as mortality, lapse rate, etc.) with similar risks.

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

Example 1. On June 30, 1959, X, a life insurance company, reinsured a portion of its insurance contracts with Y, a life insurance company, under an agreement whereby Y agreed to assume and to become solely liable under the contracts reinsured. The reserves on the contracts reinsured by X were $100,000. Under the reinsurance agreement X agreed to pay Y $100,000 for assuming such contracts and Y agreed to pay X $17,000 for the right to receive future premium payments under this block of contracts. Rather than exchange payments of money, X agreed to pay Y a net amount of $83,000 in cash. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, that there are no other insurance transactions by X or Y during the taxable year, and assuming that X and Y compute the reserves on the contracts reinsured on the same basis, X has income of $100,000 under section 809(c)(2) as a result of the net decrease in its reserves. X has a net deduction of $83,000 ($100,000 − $17,000) under section 809(d)(7). For the taxable year 1959, Y has income of $100,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of $100,000 under section 809(d)(2) for the net increase in reserves and $1,000 ($17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining $16,000 shall be amortized over the next 16 succeeding taxable years (16×$1,000=$16,000) under section 809(d)(12) at the rate of $1,000 for each such taxable year.

Example 2. The facts are the same as in example 1, except X agreed to pay Y a consideration of $100,000 in cash for assuming these contracts and Y paid X a bonus of $17,000 in cash and that this bonus meets the requirements of section 162. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, X has income of $100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of $83,000 under section 809(d)(7) for the amount of the consideration ($100,000) paid to Y for assuming these contracts, reduced by the bonus ($17,000) received from Y. For the taxable year 1959, Y has income of $100,000 under section 809(c)(1) as a result of the consideration received from X and deductions of $100,000 under section 809(d)(2) for the net increase in reserves and $1,000 (the bonus of

$17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining amount of the bonus ($16,000) shall be amortized over the next 16 succeeding taxable years (16×$1,000=$16,000) under section 809(d)(12) at the rate of $1,000 for each such taxable year.

Example 3. The facts are the same as in Example 1, except that the reinsurance agreement does not specifically provide that X agreed to pay Y $100,000 for assuming the contracts reinsured and Y agreed to pay X $17,000 for the right to receive future premium payments under such contracts. Instead, X agreed to pay Y a net amount of $83,000 in cash for assuming such contracts. Nevertheless, Y is treated as having received from X consideration equal to $100,000, the amount of the increase in Y's reserves, and as having paid $17,000 ($100,000 less $83,000) for the purchase of such contracts. Therefore, for the taxable year 1959, Y has income of $100,000 under section 809(c)(1). Y also has a deduction of $100,000 under section 809(d)(2) for the net increase in its reserves and an amortization deduction under section 809(d)(12) of $1,000 ($17,000 divided by 17, the reasonably estimated life of the contracts reinsured). The remaining $16,000 shall be amortized by Y over the next 16 succeeding years at the rate of $1,000 for each such year. For 1959, X has income of $100,000 under section 809(c)(2) as a result of the net decrease in its reserves and a deduction of $83,000 under section 809(d)(7) for the net amount of consideration paid to Y for assuming the contracts reinsured.

Example 4. The facts are the same as in example 1, except that X agreed to pay Y a consideration of $130,000 in cash for assuming such contracts. Based upon these facts, X has income of $100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of $130,000 under section 809(d)(7) for the amount of the consideration paid to Y for assuming these contracts. Y has income of $130,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of $100,000 under section 809(d)(2) for the net increase in its reserves.

Example 5. On August 1, 1960, R, a life insurance company, reinsured all of its insurance policies with S, a life insurance company, under an agreement whereby S agreed to assume and become solely liable under the contracts reinsured. The reserves on the contracts reinsured by R were $3,000,000. Under the reinsurance agreement, R agreed to pay S a consideration of $3,000,000 in stocks and bonds for assuming such contracts. Assuming no other insurance transactions by R or S during the taxable year, that R and S compute the reserves on the contracts reinsured on the same basis, and that R has a recognized gain (after the application of the limitation of section 817(b)(1)) of $20,000 due to appreciation in value of the assets transferred, the results to each company are as follows:

Company R (reinsured)	
Net decrease in reserves (sec. 809(c) (2))	$3,000,000
Capital gain (as limited by sec. 817(b) (1)) to be taxed separately under sec. 802(a)(2)	20,000
Consideration paid by R to S in respect of S's assuming liabilities under contracts issued by R (sec. 809(d)(7))	$3,000,000
INCOME	
Company S (reinsurer)	
Consideration received by S in respect of assuming liabilities under contracts issued by R (sec. 809(c)(1))	$3,000,000
DEDUCTIONS	
Net increase in reserves (sec.809(d)(2))	$3,000,000

[T.D. 6558, 26 FR 2783, Apr. 4, 1961, as amended by T.D. 6625, 27 FR 12543, Dec. 19, 1962; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 41 FR 5100, Feb. 4, 1976]

§ 1.817–5 Diversification requirements for variable annuity, endowment, and life insurance contracts.

(a) *Consequences of nondiversification*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, for purposes of subchapter L, section 72, and section 7702(a), a variable contract (as defined in section 817(d)), other than a pension plan contract (as defined in section 818(a)), which is based on one or more segregated asset accounts shall not be treated as an annuity, endowment, or life insurance contract for any calendar quarter period for which the investments of any such account are not adequately diversified. For this purpose, a variable contract shall be treated as based on a segregated asset account for a calendar quarter period if amounts received under the contract (or earnings thereon) are allocated to the segregated asset account at any time during the period. In addition, a variable contract that is not treated as an annuity, endowment, or life insurance contract for any period by reason of this paragraph (a)(1) shall not be treated as an annuity, endowment, or life insurance contract for any subsequent period even if the investments are adequately diversified for such subsequent period. If a variable contract which is a life insurance or endowment contract under other applicable (e.g., State or foreign) law is not treated as a life insurance or endowment contract under section 7702(a), the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during such year in accordance with section 7702 (g) and (h). Likewise, if a variable contract is not treated as an annuity contract under section 72, the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year in the same manner as a life insurance or endowment contract under section 7702 (g) and (h).

(2) *Inadvertent failure to diversify.* The investments of a segregated asset account shall be treated as satisfying the requirements of paragraph (b) of this section for one or more periods, provided the following conditions are satisfied—

(i) The issuer or holder must show the Commissioner that the failure of the investments to satisfy the requirements of paragraph (b) of this section for such period or periods was inadvertent,

(ii) The investments of the account must satisfy the requirements of paragraph (b) of this section within a reasonable time after the discovery of such failure, and

(iii) The issuer or holder of the variable contract must agree to make such adjustments or pay such amounts as may be required by the Commissioner with respect to the period or periods during which the investments of the account did not satisfy the requirements of paragraph (b) of this section. The amount required by the Commissioner to be paid shall be an amount based upon the tax that would have been owed by the policyholders if they were treated as receiving the income on the contract (as defined in section 7702(g)(1)(B), without regard to section 7702(g)(1)(C)) for such period or periods.

(b) *Diversification of investments*—(1) *In general.* (i) Except as otherwise provided in this paragraph and paragraph (c) of this section, the investments of a segregated asset account shall be considered adequately diversified for purposes of this section and section 817(h) only if—

(A) No more than 55% of the value of the total assets of the account is represented by any one investment;

(B) No more than 70% of the value of the total assets of the account is represented by any two investments;

(C) No more than 80% of the value of the total assets of the account is represented by any three investments; and

(D) No more than 90% of the value of the total assets of the account is represented by any four investments.

(ii) For purposes of this section—

(A) All securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment; and

(B) In the case of government securities, each government agency or instrumentality shall be treated as a separate issuer.

(iii) See paragraph (f) of this section for circumstances in which a segregated asset account is treated as the owner of assets held indirectly through certain pass-through entities and corporations taxed under subchapter M, chapter 1 of the Code.

(2) *Safe harbor.* A segregated asset account will be considered adequately diversified for purposes of this section and section 817(h) if—

(i) The account meets the requirements of section 851 (b)(4) and the regulations thereunder; and

(ii) No more than 55% of the value of the total assets of the account is attributable to cash, cash items (including receivables), government securities, and securities of other regulated investment companies.

(3) *Alternative diversification requirements for variable life insurance contracts.* (i) A segregated asset account with respect to variable life insurance contracts will be considered adequately diversified for purposes of this section and section 817(h) if the requirements of paragraph (b)(1) or (b)(2) of this section are satisfied or if the assets of such account, other than Treasury securities, satisfy the percentage limitations prescribed in paragraph (b)(1) of this section increased by the product of (A) .5 and (B) the percentage of the value of the total assets of the account that is represented by Treasury securities. In determining whether the assets of an account, other than Treasury securities, satisfy the increased percentage limitations, such limitations are

applied as if the Treasury securities were not included in the account (*i.e.*, the increased percentage limitations are not applied to Treasury securities and the value of the total assets of the account is reduced by the value of the Treasury securities).

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

Example 1. On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,000. The assets of the account are represented by Treasury securities having a total value of $90,000 and securities of Corporation A having a total value of $10,000. The 55% limit described in paragraph (b)(1)(i) of this section would be increased by 45% (0.5×90%) to 100%, and would then be applied to the assets of the account other than Treasury securities. Because no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporation A, the investments of the account will be considered adequately diversified.

Example 2. On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,000. The assets of the account are represented by Treasury securities having a total value of $60,000, securities of Corporation A having a total value of $30,000, and securities of Corporation B having a total value of $10,000. The 55% and 70% limits described in paragraph (b)(1)(i) of this section would be increased by 30% (0.5×60%) to 85% and 100%, respectively, and would then be applied to the assets of the account other than Treasury securities. Securities of Corporation A represent 75%, and securities of Corporation B represent 25%, of the value of the assets of the account other than Treasury securities. Because no more than 85% of the value of the assets other than Treasury securities is represented by securities of Corporation A or B and no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporations A and B, the investments of the account will be considered adequately diversified.

(c) *Periods for which an account is adequately diversified*—(1) *In general.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the last day of a quarter of a calendar year (*i.e.*, March 31, June 30, September 30, and December 31) or within 30 days after such last day shall be considered adequately diversified for such quarter.

(2) *Start-up period.* (i) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is not a real property account on its first anniversary shall be considered adequately diversified until such first anniversary.

(ii) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is a real property account on its first anniversary shall be considered adequately diversified until the earlier of its fifth anniversary or the anniversary on which the account ceases to be a real property account.

(iii) For purposes of paragraph (c)(2) (i) and (ii) of this section, the anniversary of a segregated asset account is the anniversary of the date on which any amount received under a life insurance or annuity contract, other than a pension plan contract (as defined in section 818 (a)), is first allocated to the account.

(iv) If more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than one year before such date, paragraph (c)(2)(i) of this section shall not apply to the segregated asset account for any period after such date. Similarly, if more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than 5 years before such date, paragraph (c)(2)(ii) of this section shall not apply to the segregated asset account for any period after such date. For purposes of this paragraph (c)(2), amounts transferred to the account from a diversified account (determined without regard to this paragraph (c)(2)) or as a result of an exchange pursuant to section 1035 in which the issuer of the contract received in the exchange is not related in a manner specified in section 267(b) to the issuer of the contract transferred in the exchange are not treated as—

(A) Amounts attributable to contracts entered into more than one year before such date, in the case of accounts subject to paragraph (c)(2)(i) of this section, or

(B) Amounts attributable to contracts entered into more than five years before such date, in the case of accounts subject to paragraph (c)(2)(ii) of this section.

(3) *Liquidation period.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the date a plan of liquidation is adopted shall be considered adequately diversified for—

(i) The one-year period beginning on the date the plan of liquidation is adopted if the account is not a real property account on such date; or

(ii) The two-year period beginning on the date the plan of liquidation is adopted if the account is a real property account on such date.

(d) *Market fluctuations.* A segregated asset account that satisfies the requirements of paragraph (b) of this section at the end of any calendar quarter (or within 30 days after the end of such calendar quarter) shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition.

(e) *Segregated asset account.* For purposes of section 817(h) and this section, a segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets. See paragraph (g) for examples illustrating the application of this paragraph (e).

(f) *Look-through rule for assets held through certain investment companies, partnerships, or trusts*—(1) *In general.* If this paragraph (f) applies, a beneficial interest in a regulated investment company, a real estate investment trust, a partnership, or a trust that is treated under sections 671 through 679 as owned by the grantor or another person (''investment company, partnership, or trust'') shall not be treated as a single investment of a segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust shall be treated, for purposes of this section, as an asset of the segregated asset account. For purposes of this section, the ratable interest of a partner in a partnership's assets shall be determined in accordance with the partner's capital interest in the partnership.

(2) *Applicability*—(i) *Certain investment companies, partnerships, and trusts.* This paragraph (f) shall apply to an investment company, partnership, or trust if—

(A) All the beneficial interests in the investment company, partnership, or trust (other than those described in paragraph (f)(3) of this section) are held by one or more segregated asset accounts of one or more insurance companies; and

(B) Public access to such investment company, partnership, or trust is available exclusively (except as otherwise permitted in paragraph (f)(3) of this section) through the purchase of a variable contract. Solely for this purpose, the status of a contract as a variable contract will be determined without regard to section 817(h) and this section.

(ii) *Nonregistered partnerships.* This paragraph (f) shall also apply to a partnership interest if the partnership interest is not registered under a Federal or State law regulating the offering or sale of securities.

(iii) *Trusts holding Treasury securities.* This paragraph (f) shall also apply to a trust that is treated under section 671 through 679 as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

(3) *Interests not held by segregated asset accounts.* Satisfaction of the requirements of paragraph (f)(2)(i) of this section shall not be prevented by reason of beneficial interests in the investment company, partnership, or trust that are—

(i) Held by the general account of a life insurance company or a corporation related in a manner specified in section 267(b) to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(ii) Held by the manager, or a corporation related in a manner specified in section 267(b) to the manager, of the investment company, partnership, or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership, or trust, the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), and there is no intent to sell such interests to the public;

(iii) Held by the trustee of a qualified pension or retirement plan; or

(iv) Held by the public, or treated as owned by policyholders pursuant to Rev. Rul. 81–225, 1981–2 C.B. 12, but only if (A) the investment company, partnership, or trust was closed to the public in accordance with Rev. Rul. 82–55, 1982–1 C.B. 12, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders prior to September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

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

Example 1. (i) The assets underlying variable contracts issued by a life insurance company consist of two groups of assets: (a) a diversified portfolio of debt securities and (b) interests in P, a partnership that is publicly registered. All of the beneficial interests in P are held by one or more segregated asset accounts of one or more insurance companies and public access to P is available exclusively through the purchase of a variable contract. The variable contracts provide that policyholders may specify which portion of each premium is to be invested in the debt securities and which portion is to be invested in P interests. The portfolio of debt securities and the assets of P, considered separately, each satisfy the diversification requirements of paragraph (b) of this section.

(ii) As a result of the ability of policyholders to allocate premiums among the two groups of assets, the investment return and market value of the interests in P and the debt securities may be allocated to different variable contracts in a non-identical manner. Accordingly, under paragraph (e) of this section, the interests in P are treated as part of a single segregated asset account (''Account 1'') and the debt securities are treated as part of a different segregated asset account (''Account 2'').

(iii) Since P is described in paragraph (f)(2)(i) of this section, interests in P will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of P.

(iv) Since Account 1 and Account 2 each satisfy the requirements of paragraph (b) of this section, variable contracts that are based on either or both accounts are treated as annuity, endowment, or life insurance contracts.

Example 2. The facts are the same as in example 1 except that some of the beneficial interests in P are held by persons not described in paragraph (f)(3) of this section. Since P is not described in paragraph (f)(2) of this section, interests in P will be treated as a single investment of Account 1. As a result, Account 1 does not satisfy the requirements of paragraph (b) of this section. Variable contracts based in whole or in part on Account 1 are not treated as annuity, endowment, or life insurance contracts. Variable contracts that are not based on Account 1 at any time during the period in which such account fails to satisfy the requirements of paragraph (b) of this section (*i.e.*, contracts based entirely on Account 2), are treated as annuity, endowment, or life insurance contracts. See paragraph (a)(1).

Example 3. The facts are the same as in example 2 except that P is not publicly registered. Since P is described in paragraph (e)(2)(ii) of this section, the result is the same as in example 1.

Example 4. The facts are the same as in example 2 except that the variable contracts do not permit policyholders to allocate premiums between or among the debt securities and interests in P. Thus, the investment return and market value of the interests in P and the debt securities must be allocated to the same variable contracts and in an identical manner. Under paragraph (e) of this section, the interests in P and the debt securities are treated as part of a single segregated asset account. If the interests in P and the debt securities, considered together, satisfy the requirements of paragraph (b) of this section, contracts based on this segregated asset account will be treated as annuity, endowment, or life insurance contracts.

(h) *Definitions.* The terms defined below shall, for purposes of this section, have the meanings set forth in such definitions:

(1) *Government security*—(i) *General rule.* The term *government security* shall mean any security issued or guaranteed or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing. Any security or certificate or deposit insured or guaranteed only in part by the United States or an instrumentality thereof is treated as issued by the United States or its instrumentality only to the extent so insured or guaranteed, and as issued by the direct obligor to the extent not so insured or guaranteed. For purposes of this paragraph (h)(1), an instrumentality of the United States shall mean any person that is treated for purposes of 15 U.S.C. 80a–2 (16), as amended, as a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.

(ii) *Example.* A segregated asset account purchases a certificate of deposit in the amount of $150,000 from bank A. Deposits in bank A are insured by the Federal Deposit Insurance Corporation, an instrumentality of the United States, to the extent of $100,000 per depositor. The certificate of deposit is treated as a government security to the extent of the $100,000 insured amount and is treated as a security issued by bank A to the extent of the $50,000 excess of the value of the certificate of deposit over the insured amount.

(2) *Treasury security*—(i) *General rule.* For purposes of paragraph (b)(3) of this section and section 817(h)(3), the term *Treasury security* shall mean a security the direct obligor of which is the United States Treasury.

(ii) *Example.* A segregated asset account purchases put and call options on U.S. Treasury securities issued by the Options Clearing Corporation. The options are not Treasury securities for purposes of paragraph (b)(3) and section 817(h)(3) because the direct obligor of the options is not the United States Treasury.

(3) *Real property.* The term *real property* shall mean any property that is treated as real property under 1.856–3 (d) except that it shall not include interests in real property.

(4) *Real property account.* A segregated asset account is a real property account on an anniversary of the account (within the meaning of paragraph (c)(2)(iii) of this section) or on the date a plan of liquidation is adopted if not less than the applicable percentage of the total assets of the account is represented by real property or interests in real property on such anniversary or date. For this purpose, the applicable percentage is 40% for the period ending on the first anniversary of the date on which premium income is first received, 50% for the year ending on the second anniversary, 60% for the year ending on the third anniversary, 70% for the year ending on the fourth anniversary, and 80% thereafter. A segregated asset account will also be treated as a real property account on its first anniversary if on or before such first anniversary the issuer has stated in the contract or prospectus or in a submission to a regulatory agency, an intention that the assets of the account will be primarily invested in real property or interests in real property, provided that at least 40% of the total assets of the account are so invested within six months after such first anniversary.

(5) *Commodity.* The term *commodity* shall mean any type of personal property other than a security.

(6) *Security.* The term *security* shall include a cash item and any partnership interest registered under a Federal or State law regulating the offering or sale of securities. The term shall not include any other partnership interest, any interest in real property, or any interest in a commodity.

(7) *Interest in real property.* The term *interest in real property* shall include the ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term shall not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c)

apply. The term ''interest in real property'' also shall include options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(8) *Interest in a commodity.* The term *interest in a commodity* shall include the ownership and co-ownership of any type of personal property other than a security, and any leaseholds thereof. Such term shall include mineral, oil, and gas royalty interests, including any fractional undivided interest therein. Such term also shall include any put, call, straddle, option, or privilege on any type of personal property other than a security.

(9) *Value.* The term *value* shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account.

(10) *Terms used in section 851.* To the extent not inconsistent with this paragraph (h) all terms used in this section shall have the same meaning as when used in section 851.

(i) *Effective date*—(1) *In general.* This section is effective for taxable years beginning after December 31, 1983.

(2) *Exceptions.* (i) If, at all times after December 31, 1983, an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81–225, 1981–2 C.B. 12, this section will not apply to such account until December 15, 1986.

(ii) This section will not apply to any variable contract to which Rev. Rul. 77–85, 1977–1 C.B. 12, or Rev. Rul. 81–225, 1981–2 C.B. 12, did not apply by reason of the limited retroactive effect of such rulings.

(iii) In determining whether a segregated asset account is adequately diversified for any calendar quarter ending before July 1, 1988, debt instruments that are issued, guaranteed, or insured by the United States or an instrumentality of the United States shall not be treated as government securities if such debt instruments are secured by a mortgage on real property (other than real property owned by the United States or an instrumentality of the United States) or represent an interest in a pool of debt instruments secured by such mortgages.

(iv) This section shall not apply until January 1, 1989, with respect to a variable contract (as defined in section 817(d)) that (1) provides for the payment of an immediate annuity (as defined in section 72(u)(4)); (2) was outstanding on September 12, 1986; and (3) the segregated asset account on which it was based was, on September 12, 1986, wholly invested in deposits insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

[T.D. 8242, 54 FR 8730, Mar. 2, 1989; T.D. 8242, 54 FR 11866, Mar. 22, 1989]

§ 1.817A–0 Table of contents.

This section lists the captions that appear in section § 1.817A–1:

[T.D. 9058, 68 FR 24350, May 7, 2003]

§ 1.817A–1 Certain modified guaranteed contracts.

(a) *Definitions*—(1) *Modified guaranteed contract.* The term *modified guaranteed contract* (MGC) is defined in section 817A(d) as an annuity, life insurance, or pension plan contract (other than a variable contract described in section 817) under which all or parts of the amounts received under the contract are allocated to a segregated account. Assets and reserves in this segregated account must be valued from time to time with reference to market values for annual statement purposes. Further, an MGC must provide either for a net surrender value or for a policyholder's fund (as defined in section 807(e)(1)). If only a portion of a contract is not described in section 817, such portion is treated as a separate contract for purposes of applying section 817A.

(2) *Temporary guarantee period.* An MGC may temporarily guarantee a return other than the permanently guaranteed crediting rate for a period specified in the contract (the *temporary guarantee period*). During the temporary guarantee period, the amount paid to the policyholder upon surrender is usually increased or decreased by a market value adjustment, which is determined by a formula set forth under the terms of the MGC.

(3) *Equity-indexed modified guaranteed contract.* An equity-indexed MGC is an MGC, as defined in paragraph (a)(1) of this section, that provides a return during or at the end of the temporary guarantee period based on the performance of stocks, other equity instruments, or equity-based derivatives.

(4) *Non-equity-indexed modified guaranteed contract.* A non-equity-indexed MGC is an MGC, as defined in paragraph (a)(1) of this section, that provides a return during or at the end of the temporary guarantee period not based on the performance of stocks, other equity instruments, or equity-based derivatives.

(5) *Current market rate for non-equity-indexed modified guaranteed contracts.* The current market rate for a non-equity-indexed MGC issued by an insurer (whether issued in that tax year or a previous one) is the appropriate Treasury constant maturity interest rate published by the Board of Governors of the Federal Reserve System for the month containing the last day of the insurer's taxable year. The appropriate rate is that rate published for Treasury securities with the shortest published maturity that is greater than (or equal to) the remaining duration of the current temporary guarantee period under the MGC.

(6) *Current market rate for equity-indexed modified guaranteed contracts.* [Reserved]

(b) *Applicable interest rates for non-equity-indexed modified guaranteed contracts*—(1) *Tax reserves during temporary guarantee period.* An insurance company is required to determine the tax reserves for an MGC under sections 807(c)(3) or (d)(2). During a non-equity-indexed MGC's temporary guarantee period, the applicable interest rate to be used under sections 807(c)(3) and (d)(2)(B) is the current market rate, as defined in paragraph (a)(5) of this section.

(2) *Required interest during temporary guarantee period.* During the temporary guarantee period of a non-equity-indexed MGC, the applicable interest rate to be used to determine required interest under section 812(b)(2)(A) is the same current market rate, defined in paragraph (a)(5) of this section, that applies for that period for purposes of sections 807(c)(3) or (d)(2)(B).

(3) *Application of section 811(d).* An additional reserve computation rule applies under section 811(d) for contracts that guarantee certain interest payments beyond the end of the taxable year. Section 811(d) is waived for non-equity-indexed MGCs.

(4) *Periods after the end of the temporary guarantee period.* For periods after the end of the temporary guarantee period, sections 807(c)(3), 807(d)(2)(B), 811(d) and 812(b)(2)(A) are not modified when applied to non-equity-indexed MGCs. None of these sections are affected by the definition of current market rate contained in paragraph (a)(5) of this section once the temporary guarantee period has expired.

(5) *Examples.* The following examples illustrate this paragraph (b):

Example 1. (i) *IC,* a life insurance company as defined in section 816, issues a MGC (the Contract) on August 1 of 1996. The Contract is an annuity contract that gives rise to life insurance reserves, as defined in section 816(b). *IC* is a calendar year taxpayer. The Contract guarantees that interest will be credited at 8 percent per year for the first 8 contract years and 4 percent per year thereafter. During the 8-year temporary guarantee period, the Contract provides for a market value adjustment based on changes in a published bond index and not on the performance of stocks, other equity instruments or equity based derivatives. IC has chosen to avail itself of the provisions of these regulations for 1996 and taxable years thereafter. The 10-year Treasury constant maturity interest rate published for December of 1996 was 6.30 percent. The next shortest maturity published for Treasury constant maturity interest rates is 7 years. As of the end of 1996, the remaining duration of the temporary guarantee period for the Contract was 7 years and 7 months.

(ii) To determine under section 807(d)(2) the end of 1996 reserves for the Contract, *IC* must use a discount interest rate of 6.30 percent for the temporary guarantee period. The interest rate to be used in computing required interest under section 812(b)(2)(A) for 1996 reserves is also 6.30 percent.

(iii) The discount rate applicable to periods outside the 8-year temporary guarantee period is determined under sections 807(c)(3), 807(d)(2)(B), 811(d) and 812(b)(2)(A) without regard to the current market rate.

Example 2. Assume the same facts as in *Example 1* except that it is now the last day of 1998. The remaining duration of the temporary guarantee period under the Contract is now 5 years and 7 months. The 7-year Treasury constant maturity interest rate published for December of 1998 was 4.65 percent. The next shortest duration published for Treasury constant maturity interest rates is 5 years. A discount rate of 4.65 percent is used for the remaining duration of the temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

Example 3. Assume the same facts as in *Example 1* except that it is now the last day of 2001. The remaining duration of the temporary guarantee period under the Contract is now 2 years and 7 months. The 3-year Treasury constant maturity interest rate published for December of 2001 was 3.62 percent. The next shortest duration published for Treasury constant maturity interest rates is 2 years. A discount rate of 3.62 percent is used for the remaining duration of the temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

(c) *Applicable interest rates for equity-indexed modified guaranteed contracts.* [Reserved]

(d) *Effective date.* Paragraphs (a), (b) and (d) of this section are effective on May 7, 2003. However, pursuant to section 7805(b)(7), taxpayers may elect to apply those paragraphs retroactively for all taxable years beginning after December 31, 1995, the effective date of section 817A.

[T.D. 9058, 68 FR 24350, May 7, 2003]

§ 1.818–1 Taxable years affected.

Sections 1.818–2 through 1.818–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2785, Apr. 4, 1961 as amended by T.D. 7469, 42 FR 12181, Mar. 3, 1977]

§ 1.818–2 Accounting provisions.

(a) *Method of accounting.* (1) Section 818(a)(1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term ''accrual method'' shall have the same meaning and application in section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of expenses under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a)(2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a)(2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term ''method of accounting'' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item.

For purposes of section 818(a)(2), a life insurance company may elect to compute its taxable income under an overall method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(3)(i) An election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provisions of the Internal Revenue Code of 1954 or prior revenue laws for purposes of determining a company's tax liabilities for prior years, shall have the same force and effect in determining the items of gross investment income under section 804(b) and the items of deduction under section 804(c) of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) as if such Act had not been enacted.

(ii) For purposes of determining gain or loss from operations under section 809(b), in computing the life insurance company's share of investment yield under section 809(b) (1)(A) and (2)(A), an election with respect to any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provision of the Internal Revenue Code of 1954 or prior revenue laws, shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

(iii) For purposes of determining gain or loss from operations under section 809(b), in computing the items of gross amount under section 809(c) and the deduction items under section 809(d), an election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph must be made in accordance with the specific statutory provisions of the sections containing such elections and the regulations thereunder. However, where a particular election may be made only with the consent of the Commissioner (either because the time for making the election without the consent of the Commissioner has expired or because the particular section contained no provision for making an election without consent), and the time prescribed by the applicable regulations for submitting a request for permission to make such an election for the taxable year 1958 has expired, a life insurance company may make such an election for the year 1958 at the time of filing its return for that year (including extensions thereof). For example, a life insurance company may elect any of the methods of depreciation prescribed in section 167 (to the extent permitted under that section and the regulations thereunder) with respect to those assets, or any portion thereof, for which no depreciation was allowable under prior revenue laws, for example, furniture and fixtures used in the underwriting department. Similarly, a life insurance company shall be permitted to make an election under section 461(c) (relating to the accrual of real property taxes) with respect to real property for which no deduction was allowable under prior revenue laws. Any such election shall be made in the manner and form prescribed in the applicable regulations.

(iv) For purposes of subdivision (ii) of this subparagraph, the method used under section 1016(a)(3)(C) (relating to adjustments to basis) in determining the amount of exhaustion, wear and tear, obsolescence, and amortization actually sustained shall not preclude a taxpayer from electing any of the methods prescribed in section 167 in accordance with the provisions of that section and the regulations thereunder for determining the amount of such exhaustion, wear and tear, obsolescence, and amortization for the year 1958. For example, if the amount of depreciation actually sustained, under section 1016(a)(3)(C), on a life insurance company's home office building (other than that portion for which depreciation was allowable under prior revenue laws) is determined on the straight line method, the life insurance company may elect for the year 1958 to use any of the methods prescribed in section 167 for determining its depreciation allowance for 1958. However, such election shall be binding for 1958, and for all subsequent taxable years, unless consent to change such election, if required, is obtained from the Commissioner in accordance with the provisions of section 167 and the regulations thereunder.

(4)(i) For purposes of section 805(b)(3)(B)(i) (relating to the determination of the current earnings rate for any taxable year beginning before January 1, 1958), the determination for any year of the investment yield and the assets shall be made as though the taxpayer had been on the accrual method prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in determining the investment yield and assets for the taxable year 1958. However, where the method used for determining the deduction under section 167 for the year 1958 differs from the method used in prior years, the amount of the deduction actually allowed or allowable for such prior years for purposes of section 1016(a)(2) (relating to adjustments to basis) shall be the amount to be taken into account in determining the current earnings rate under section 805(b)(3)(B)(i).

(ii) For purposes of section 812(b)(1)(C) (relating to operations loss carrybacks and carryovers for years prior to 1958), the determination for those years of the gain or loss from operations shall be made as though the taxpayer had been on the accrual method of accounting prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in the determination of gain or loss from operations for the taxable year 1958. However, where any adjustment to basis is required under section 1016(a)(3)(C) on account of exhaustion, wear and tear, obsolescence, amortization, and depletion sustained, the amount actually sustained as determined under section 1016(a)(3)(C) for each of the years involved shall be the amount allowed in the determination of gain or loss from operations for purposes of section 812(b)(1)(C).

(b) *Adjustments required if accrual method of accounting was not used in 1957.* The items of gross amount taken into account under section 809(c) and the items of deductions allowed under section 809(d) for the taxable year 1958 shall be determined as though the taxpayer had been on the accrual method of accounting prescribed in paragraph (a) of this section for all prior years. Thus, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of gross amount which would have been properly taken into account for the year 1957 if the company had been on the accrual method described in section 818(a). Likewise, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of deductions which would have been properly allowed for the year 1957 if the company had been on the accrual method described in section 818(a). For example, if certain premium amounts were received during the year 1958 but such amounts would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be required to take such premium amounts into account for the year 1958. If, for example, certain claims, benefits, and losses were paid during the year 1958 but such items would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be permitted to deduct such expense items for the year 1958. For a special transitional rule applicable with respect to changes in method of accounting required by section 818(a) and paragraph (a) of this section, see section 818(e) and § 1.818–6.

(c) *Change of basis in computing reserves.* (1) Section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), the amount of such item shall be the amount computed on the old basis as of the close of the taxable year and the amount computed on the new basis as of the beginning of the next taxable year. Similarly, section 810(d)(1) provides rules for determining the amount of the adjustment to be made for purposes of subpart C, part I, subchapter L, chapter 1 of the Code (relating to the determination of gain or loss from operations), if the basis for determining any item referred to in section 810(c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year. Under an accrual method of accounting, a change in the basis or method of computing the amount of liability of any item referred to in section 810(c) occurs in the taxable year in which all the events have occurred which determine the change in the basis or method of computing the amount of such liability and, in which, the amount thereof (whether increased or decreased) can be determined with reasonable accuracy.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. Assume that during the taxable year 1960, M, a life insurance company, determines that the amount of its life insurance reserves held with respect to a particular block of contracts is understated on the present basis being used in valuing such liability and that such liability can be more accurately reflected by changing from the present basis to a particular new basis. Assume that M uses such new basis in computing its reserves under such contracts at the end of the taxable year 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine the change in basis and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy. Such change shall be treated as having occurred during the taxable year 1960 whether M determines that its liability under such contracts was understated for the first time during 1960, or that its liability under such contracts has, in fact, been understated for a number of prior years.

Example 2. Assume the facts are the same as in example 1, except that during the taxable year 1960 the insurance department of State X issues a ruling, pursuant to authority conferred by statute, requiring M to use the particular new basis which more accurately reflects its liability with respect to such contracts and that as a result of such ruling, M uses the new basis in computing its reserves under such contracts for the taxable years 1958, 1959, and 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine that a change in basis should be made and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy.

[T.D. 6558, 26 FR 2785, Apr. 4, 1961]

§ 1.818–3 Amortization of premium and accrual of discount.

(a) *In general.* Section 818(b) provides that the appropriate items of income, deductions, and adjustments under part I, subchapter L, chapter 1 of the Code, shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. The adjustment for accrual of discount increases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the exclusion and reduction for wholly tax-exempt interest. See section 103.

(b) *Acquisitions before January 1, 1958.* (1) In the case of any such security acquired before January 1, 1958, the premium is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, its then fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(2) The adjustments for amortization of premium and accrual of discount will be determined:

(i) According to the method regularly employed by the company, if such method is reasonable, or

(ii) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed ''regularly employed'' by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(3) The method of amortization and accrual prescribed by this section is as follows:

(i) The premium (or discount) shall be determined in accordance with this section; and

(ii) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For purposes of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered a month.

(c) *Acquisitions after December 31, 1957.* (1) In the case of:

(i) Any bond, as defined in section 171(d), acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under section 171(b) and the regulations thereunder, as if the election set forth in section 171(c) had been made, and

(ii) Any bond, note, debenture, or other evidence of indebtedness not described in subdivision (i) of this subparagraph and acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under paragraph (b) of this section.

(2) In the case of any bond, note, debenture, or other evidence of indebtedness acquired after December 31, 1957, the amount of the discount and the accrual of discount attributable to the taxable year shall be determined under paragraph (b) of this section.

(d) *Convertible evidences of indebtedness.* Section 818(b)(2)(B) provides that in no case shall the amount of premium on a convertible evidence of indebtedness (including any bond, note, or debenture) include any amount attributable to the conversion features of the evidence of indebtedness. This provision is the same as the one contained in section 171(b), and the rules prescribed in paragraph (c) of § 1.171–2 shall be applicable for purposes of section 818(b)(2)(B). This provision is to be applied without regard to the date upon which the evidence of indebtedness was acquired. Thus, where a convertible evidence of indebtedness was acquired before January 1, 1958, and a portion or all of the premium attributable to the conversion features of the evidence of indebtedness has been amortized for taxable years beginning before January 1, 1958, no adjustment for such amortization will be required by reason of section 818(b)(2)(B). Such amortization will, however, require an adjustment to the basis of the evidence of indebtedness under section 1016(a)(17). For taxable years beginning after December 31, 1957, no further amortization of the premium attributable to the conversion features of such an evidence of indebtedness will be taken into account.

(e) *Adjustments to basis.* Section 1016(a)(17) (relating to adjustments to basis) provides that in the case of any evidence of indebtedness referred to in section 818(b) and this section, the basis shall be adjusted to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years. The basis of any evidence of indebtedness shall be reduced by the amount of the adjustment required under section 818(b) (or the corresponding provision of prior income tax laws) on account of amortizable premium and shall be increased by the amount of the adjustment required under section 818(b) on account of accruable discounts.

(f) *Denial of double inclusion.* Any amount which is includible in gross investment income by reason of section 818(b) and paragraph (a) of this section shall not be includible in gross income under section 1232(a) (relating to the taxation of bonds and other evidences of indebtedness). See section 1232(a)(2)(C) and the regulations thereunder.

[T.D. 6558, 26 FR 2786, Apr. 4, 1961]

§ 1.818–4 Election with respect to life insurance reserves computed on preliminary term basis.

(a) *In general.* Section 818(c) permits a life insurance company issuing contracts with respect to which the life insurance reserves are computed on one of the recognized preliminary term bases to elect to revalue such reserves on a net level premium basis for the purpose of determining the amount which may be taken into account as life insurance reserves for purposes of part I, subchapter L, chapter 1 of the Code, other than section 801 (relating to the definition of a life insurance company). If such an election is made, the method to be used in making this revaluation of reserves shall be either the exact revaluation method (as described in section 818(c)(1) and paragraph (b)(1) of this section) or the approximate revaluation method (as described in section 818(c)(2) and paragraph (b)(2) of this section).

(b) *Revaluation of reserves computed on preliminary term basis.* If a life insurance company makes an election under section 818(c) in the manner provided in paragraph (e) of this section, the amount to be taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases:

(1) *Exact revaluation method.* As if the reserves for all such contracts had been

computed on a net level premium basis (using the same mortality or morbidity assumptions and interest rates for both the preliminary term basis and the net level premium basis).

(2) *Approximate revaluation method.* The amount computed without regard to section 818(c):

(i) Increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

(ii) Increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

(c) *Exception.* If a life insurance company which makes an election under section 818(c)(2) and paragraph (b)(2) of this section has life insurance reserves with respect to both life insurance and noncancellable accident and health contracts for which such reserves are computed on a preliminary term basis, it shall use the approximate revaluation method for all its life insurance reserves other than that portion of such reserves held with respect to its noncancellable accident and health contracts, and shall use the exact revaluation method for all its life insurance reserves held with respect to such noncancellable accident and health contracts.

(d) *Reserves subject to recomputation.* (1) For the first taxable year for which the election under section 818(c) and paragraph (b) of this section applies, a company making such election must revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the end of such taxable year on the basis elected under section 818(c) and paragraph (b) of this section. However, for purposes of the preceding sentence, an election under section 818(c) shall not apply with respect to such reserves which would not be treated as being computed on the preliminary term basis at the end of such taxable year except for the provisions of section 810 (a) or (b). See paragraph (c)(2) of § 1.810–2. For example, if S, a life insurance company which computes its life insurance reserves on a recognized preliminary term basis at the beginning of the taxable year 1958, strengthens a portion of such reserves during the taxable year by actually changing to a net level premium basis in computing such reserves, and then makes the election under section 818(c) and paragraph (b) of this section for 1958, such election shall not apply with respect to the strengthened contracts.

(2) For any taxable year other than the first taxable year for which the election under section 818(c) and paragraph (b) of this section applies, a company making such election must revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the beginning or end of the taxable year on the basis elected under section 818(c) and paragraph (b) of this section. For example, if M, a life insurance company which made a valid outstanding election under section 818(c) in the manner provided in paragraph (e) of this section for the taxable year 1959, sells a block of contracts subject to such election on September 1, 1960, M would value such contracts on the basis elected under section 818(c) and paragraph (b) of this section on January 1, 1960, for purposes of determining the net decrease or increase in the sum of the items described in section 810(c) for the taxable year under section 810 (a) or (b).

(3) For the effect of an election under section 818(c) and paragraph (b) of this section in determining gain or loss from operations for the taxable year, see paragraph (c)(3) of § 1.810–2 and paragraph (e) of § 1.810–3.

(e) *Time and manner of making election.* The election provided by section 818(c) shall be made in a statement attached to the life insurance company's income tax return for the first taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which the company desires the election to apply falls before April 4, 1961, the election provided by section 818(c) may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before July 4, 1961. The statement shall indicate whether the exact or the approximate method of revaluation has been adopted. The statement shall also set forth sufficient information as to mortality and morbidity asumptions; interest rates; the valuation method used; the amount of the reserves and the amount and type of insurance in force under all contracts for which reserves are computed on a preliminary term basis; and such other pertinent data as will enable the Commissioner to determine the correctness of the application of the revaluation method adopted and the accuracy of the computations involved in revaluing the reserves. The election to use either the exact revaluation method or the approximate revaluation method shall, except for the purposes of section 801, be adhered to in making the computations under part I for the taxable year for which such election is made and for all subsequent taxable years.

(f) *Scope of election.* An election made under section 818(c) and paragraph (b) of this section to use either the exact or the approximate method of revaluing the company's life insurance reserves shall be binding for the taxable year for which made, and, except as provided in paragraph (g) of this section, shall be binding for all succeeding taxable years, unless consent to revoke the election is obtained from the Commissioner. However, for taxable years beginning prior to April 4, 1961, a company may revoke the election provided by section 818(c) without obtaining consent from the Commissioner by filing, before July 4, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(g) *Special rule for 1958.* If an election is made for a taxable year beginning in 1958 to use the approximate revaluation method described in section 818(c)(2) and paragraph (b)(2) of this section the company may, for its first taxable year beginning after 1958, elect to change to the exact revaluation method described in section 818(c)(1) and paragraph (b)(1) of this section without obtaining the consent of the Commissioner. In such case, the election to change shall be made in a statement attached to the company's income tax return for such taxable year and filed not later than the date prescribed by law (including extensions thereof) for filing the return for such year. The statement shall indicate that the company has elected to change from the approximate to the exact revaluation method for such taxable year and shall include such information and data referred to in paragraph (e) of this section as will enable the Commissioner to determine the correctness and accuracy of the computations involved.

[T.D. 6558, 26 FR 2787, Apr. 4, 1961; 26 FR 3276, Apr. 18, 1961]

§ 1.818–5 Short taxable years.

(a) *In general.* Section 818(d) provides that if any return of a corporation made under part I, subchapter L, chapter 1 of the Code, is for a period of less than the entire calendar year, then section 443 (relating to returns for a period of less than 12 months) shall not apply. This section further provides certain rules to be used in determining the life insurance company taxable income for a period of less than the entire calendar year.

(b) *Returns for periods of less than the entire calendar year.* A return for a short period, that is, for a taxable year consisting of a period of less than the entire calendar year, shall be made only under the following circumstances:

(1) If a company which qualifies as a life insurance company is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a life insurance company organized on August 1, is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, if a company which qualifies as a life insurance company

completely dissolves during the taxable year it is required to file a return for the short period from January 1 to the date it goes out of existence. All items entering into the computation of taxable investment income and gain or loss from operations for the short period shall be determined on a consistent basis and in the manner provided in paragraph (c) of this section.

(2) A return must be filed for a short period resulting from the termination by the district director of a taxpayer's taxable year for jeopardy. See section 6851 and the regulations thereunder.

A company which was an insurance company for the preceding taxable year (but not a life insurance company as defined in section 801(a) and paragraph (b) of §1.801–3) and which for the current taxable year qualifies as a life insurance company shall not file a return for the short period from the time during the taxable year that it first qualifies as a life insurance company to the end of the taxable year. Similarly, an insurance company which was a life insurance company for the preceding taxable year but which for the current taxable year does not qualify as a life insurance company shall not file a return for the short period from the beginning of the taxable year to the time during the taxable year that it no longer qualifies as a life insurance company.

(c) *Computation of life insurance company taxable income for short period.* (1) If a return is made for a short period, section 818(d)(1) provides that the taxable investment income and the gain or loss from operations shall be determined on an annual basis by a ratable daily projection of the appropriate figures for the short period. The appropriate figures for the short period shall be determined on an annual basis by multiplying such figures by a fraction, the numerator of which is the number of days in the calendar year in which the short period occurs and the denominator of which is the number of days in the short period.

(2)(i) In computing taxable investment income for a short period, the investment yield, the policy and other contract liability requirements, the policyholders' share of each and every item of investment yield, and the company's share of any item of investment yield shall be determined on an annual basis.

(ii) For purposes of determining the investment yield on an annual basis, each item of gross investment income under section 804(b) and each item of deduction under section 804(c) shall be annualized in the manner provided in subparagraph (1) of this paragraph. In any case in which a limitation is placed on the amount of a deduction provided under section 804(c), the limitation shall apply to the item of deduction computed on an annual basis.

(iii) The policy and other contract liability requirements shall be determined on an annual basis in the following manner:

(a) The interest paid (as defined in section 805(e) and §1.805–8) for the short period shall be annualized in the manner prescribed in subparagraph (1) of this paragraph.

(b) The current earnings rate for the taxable year in which the short period occurs shall be determined by dividing the taxpayer's investment yield, as determined on an annual basis under subdivision (ii) of this subparagraph, by the mean of the taxpayer's assets at the beginning and end of the short period. For purposes of section 805, any reference to the current earnings rate for the taxable year in which the short period occurs means the current earnings rate as determined under this subdivision.

(c) The adjusted life insurance reserves shall be determined as provided in section 805(c), and the pension plan reserves shall be determined as provided in section 805(d).

(iv) The policyholders' share of each and every item of investment yield (as defined in section 804(a)) shall be that percentage obtained by dividing the policy and other contract liability requirements, determined under subdivision (iii) of this subparagraph, by the investment yield, determined under subdivision (ii) of this subparagraph.

(v) The taxable investment income for the short period shall be an amount (not less than zero) equal to the life insurance company's share of each and every item of investment yield, as determined under subdivision (ii) of this subparagraph, reduced by the items described in section 804(a)(2) (A) and (B). In determining these reductions under section 804(a)(2)(A) the amount of the respective items shall be the amount that is determined on an annual basis under subdivision (ii) of this subparagraph. The small business deduction, under section 804(a)(2)(B) shall be an amount (not to exceed $25,000) equal to 10 percent of the investment yield, determined under subdivision (ii) of this subparagraph, for the short period.

(vi) Except as provided in this paragraph, the determination of taxable investment income under subpart B, part I, subchapter L, chapter 1 of the Code, shall be made in accordance with all the provisions of that subpart.

(3)(i) In computing gain or loss from operations for a short period, the share of each and every item of investment yield set aside for policyholders, the life insurance company's share of each and every item of investment yield, the items of gross amount, and the items of deduction shall, except as modified by this subparagraph, be determined on an annual basis in the manner provided in subparagraph (1) of this paragraph. In any case in which a limitation is placed on the amount of a deduction provided under section 809, the limitation shall apply to the item of deduction computed on an annualized basis.

(ii) For purposes of sections 809 and 810, the investment yield shall be determined in the manner provided in subparagraph (2)(ii) of this paragraph. The share of any item of investment yield set aside for policyholders shall be that percentage obtained by dividing the required interest as determined under section 809(a)(2), by the investment yield, as determined in this subparagraph, except that if the required interest exceeds the investment yield then the share of any item of investment yield set aside for policyholders shall be 100 percent.

(iii) The items of gross amount and the items of deduction, other than the operations loss deduction under section 809(d)(4), shall be determined on an annual basis. See subdivision (iv) of this subparagraph for the manner in which the net decrease or net increase in reserves under section 810 shall be annualized.

(iv) For purposes of determining either a net decrease in reserves under section 810(a) or a net increase in reserves under section 810(b), the sum of the items described in section 810(c) as of the end of the short period shall be reduced by the amount of the investment yield not included in gain or loss from operations for the short period by reason of section 809(a)(1). The amount of investment yield excluded under section 809(a)(1) has been determined upon an annualized basis while the sum of the items described in section 180(c) at the end of the short period has been determined on an actual basis. In order to place these on the same basis, the amount of investment yield not included in gain or loss from operations by reason of section 809(a)(1), determined under subdivision (ii) shall, for purposes of section 810(a) and section 810(b), be reduced to an amount which bears the same ratio to the full amount as the number of days in the short period bears to the number of days in the entire calendar year. The net decrease or the net increase of the items referred to in section 810(c) for the short period shall then be determined, as provided in section 810(a) and section 810(b), respectively, and the result annualized.

(4) The portion of the life insurance company taxable income described in section 802(b) (1) and (2) (relating to taxable investment income and gain or loss from operations) shall be determined on an annual basis by treating the amounts ascertained under subparagraph (2) of this paragraph as the taxable investment income, and the amount ascertained under subparagraph (3) of this paragraph as the gain or loss from operations, for the taxable year.

(5) The portion of the life insurance company taxable income described in section 802(b) (1) and (2) for the short period shall be the amount which bears the same ratio to the amount ascertained under section 818(d) (2) and subparagraph (4) of this paragraph as the number of days in the short period bears to the number of days in the entire year.

(d) *Special rules.* (1) For purposes of determining the average earnings rate (as defined in section 805(b)(3)) for subsequent taxable years, the current earnings rate for the taxable year in which the short period occurs shall be the rate determined under paragraph (c)(2) of this section.

(2) For purposes of determining an operations loss deduction under section 812, the loss from operations for the short period shall be the loss from operations determined under paragraph (c)(5) of this section.

[T.D. 6558, 26 FR 2788, Apr. 4, 1961]

§ 1.818–6 Transitional rule for change in method of accounting.

(a) *In general.* Section 818(e) prescribes the rules to be followed in recomputing the taxes of a life insurance company for the taxable year 1957 in cases where the method of accounting required to be used in computing the company's taxes for 1958 under section 818(a) and paragraph (a) of § 1.818–2 is different from the method used in 1957.

(b) *Recomputation of 1957 taxes.* (1) For purposes of recomputing its taxes for 1957, a life insurance company must ascertain the net amount of those adjustments which are determined (as of the close of 1957) to be necessary solely by reason of the change to the method of accounting required by section 818(a) and paragraph (a) of § 1.818–2 in order to prevent amounts from being duplicated or omitted. Thus, for example, life insurance companies not on the accrual method of accounting for the year 1957 shall accrue, as of December 31, 1957, those items of gross investment income under section 803(b) and those items of deduction under section 803(c), as in effect for 1957, which would have been properly accruable for the year 1957 if the company had been on the accrual method of accounting.

(2) In the case of a change in the over-all method of accounting, the term ''net amount of those adjustments'' means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in the various accounts on December 31, 1957. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(3)(i) The amount of the taxpayer's tax for 1957 shall be recomputed (under the law applicable to 1957, modified as provided in section 818(e) (4) and paragraph (e) of this section) by taking into account an amount equal to one-tenth of the net amount of the adjustments determined under subparagraph (1) of this paragraph. The increase or decrease in tax attributable to the adjustments for such year is the difference between the tax for such year computed with the allocation of one-tenth of the net amount of the adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year.

(ii) The amount of increase or decrease (as the case may be) referred to in section 818(e) (2) or (3) and paragraphs (c) or (d) of this section, shall be the amount of the increase or decrease in tax ascertained in the manner described in subdivision (i) of this subparagraph, multiplied by 10.

(c) *Treatment of decrease.* Section 818(e) (2) provides that for purposes of subtitle F of the Code, if the recomputation under paragraph (b) (3) (ii) of this section results in a decrease, the amount of such decrease shall be treated as a decrease in the tax imposed for 1957; except that for purposes of computing the period of limitation on the making of refunds or the allowance of credits with respect to such overpayments, the amount of such decrease shall be treated as an overpayment of tax for 1959. No interest shall be paid, for any period before March 16, 1960, on any overpayment of the tax imposed for 1957 which is attributable to such decrease.

(d) *Treatment of increase*—(1) *In general.* Section 818(e) (3) (A) provides that for purposes of subtitle F of the Code, other than section 6016 (relating to declarations of estimated income tax by corporations) and section 6655 (relating to failure by corporations to pay estimated income tax), if the recomputation under paragraph (b) (3) (ii) of this section results in an increase, the amount of such increase shall be treated as a tax imposed for 1959. Such tax shall be payable in 10 equal annual installments, beginning with March 15, 1960.

(2) *Special rules.* Section 818(e) (3) (B) provides that for purposes of section 818(e) (3) (A) and subparagraph (1) of this paragraph:

(i) No interest shall be paid on any installment described in section 818(e) (3) (A) and subparagraph (1) of this paragraph before the time prescribed therein for the payment of such installment.

(ii) Section 6152(c) (relating to proration of deficiencies to installments) and the regulations thereunder shall apply. However, section 6152(a) (relating to the election to make installment payments) and the regulations thereunder shall not apply.

(iii) In applying section 6502(a) (1) (relating to collection after assessment) and the regulations thereunder, the assessment of any installment described in section 818(e) (3) (A) and subparagraph (1) of this paragraph shall be treated as made at the time prescribed therein for the payment of such installment.

(iv) If for any taxable year the taxpayer is not a life insurance company, the amount of the increase in tax (as determined under paragraph (b) (3) (ii) of this section), to the extent not taken into account for prior taxable years, shall be payable on the date the return for such taxable year is due (determined without regard to any extensions of time for filing such return), unless such amount is required to be taken into account by the acquiring corporation under section 381(c) (22) and the regulations thereunder.

(e) *Modifications of 1957 tax computation.* Section 818(e) (4) provides that in recomputing the taxpayer's tax for 1957 for purposes of section 818(e) (1) and paragraph (b) of this section:

(1) Section 804(b), as in effect for 1957 (relating to the maximum reserve and other policy liability deduction), shall not apply with respect to any amount required to be taken into account by reason of section 818(e) (1) and paragraph (b) of this section; and

(2) The amount of the deduction allowed by section 805, as in effect for 1957 (relating to the special interest deduction), shall not be reduced by reason of any amount required to be taken into account under section 818(e) (1) and paragraph (b) of this section.

(f) *Illustration of principles.* The application of section 818(e) and this section may be illustrated by the following examples:

Example 1. For the taxable year 1957, the life insurance taxable income of M, a life insurance company, is $200,000 computed on the cash receipts and disbursements method of accounting. The net amount of the adjustments required under section 818(e)(1) by reason of the change to the accrual method of accounting for 1958, increases M's life insurance taxable income for 1957 by $50,000. The increase in tax attributable to the change in method of accounting required by section 818(a) is $26,000, computed as follows:

(1) Life insurance taxable income before adjustments	$200,000
(2) Adjustments required by sec. 818(e) (1) (1/10×$50,000)	5,000
(3) Life insurance taxable income after adjustments (item (1) plus item (2))	205,000
(4) Tax liability after adjustments (52%×$205,000, minus $5,500)	101,100
(5) Tax liability before adjustments (52%×$200,000, minus $5,500)	98,500
(6) Excess of item (4) over item (5)	2,600
(7) Increase in tax for purposes of sec. 818(e) (3) (item (6) multiplied by 10)	26,000

Under the provisions of section 818(e)(3), one-tenth of the increase in tax for 1957 attributable to the change in method of accounting required by section 818(a), $2,600 (1/10×$26,000), was due and payable on March 15, 1960, and the balance, $23,400 (9/10×$26,000), is due and payable in equal installments on March 15th of the nine succeeding taxable years. However, if for the taxable year 1965, M is no longer a life insurance company, and section 381(c)(22) does not apply, the balance of the installments not paid in prior taxable years, $10,400 (4/10×$26,000), shall be due and payable on March 15, 1966.

Example 2. Assume the facts are the same as in example 1, except that the net amount of the adjustments required by section 818(e)(1) decreases M's life insurance taxable income for 1957 by $25,000. The decrease in tax attributable to the change in method of accounting required by section 818(a) is $13,000, computed as follows:

(1) Life insurance taxable income before adjustments	$200,000
(2) Adjustments required by sec. 818(e) (1) (1/10×$25,000)	2,500
(3) Life insurance taxable income after adjustments (item (1) minus item (2))	197,500
(4) Tax liability after adjustments (52%×$197,500, minus $5,500)	97,200
(5) Tax liability before adjustments (52%×$200,000, minus $5,500)	98,500
(6) Excess of item (5) over item (4)	1,300
(7) Decrease in tax for purposes of sec. 818(e)(2) (item (6) multiplied by 10)	13,000

Under the provisions of section 818(e)(2), the entire $13,000 decrease in tax for 1957 attributable to the change in method of accounting required by section 818(a) shall be treated as an overpayment of tax for the taxable year 1959.

[T.D. 6558, 26 FR 2789, Apr. 4, 1961]

§ 1.818–7 Denial of double deductions.

Section 818(f) provides that the same item may not be deducted more than once under subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), and more than once under subpart C, part I, subchapter L, chapter 1 of the Code (relating to the determination of gain or loss from operations).

[T.D. 6558, 26 FR 2790, Apr. 4, 1961]

§ 1.818–8 Special rules relating to consolidated returns and certain capital losses.

Section 818(g) provides that, in the case of a life insurance company filing or required to file a consolidated return under section 1501 for a taxable year, the computations of the policyholders' share of investment yield under subparts B and C, part I, subchapter L, chapter 1 of the Code (including all determinations and computations incident thereto) shall be made as if such company were not filing a consolidated return. Thus, for example, if X and Y are life insurance companies which are entitled to file a consolidated return for 1975 and X has paid dividends to Y during such taxable year, Y must include such dividends in the computation of gross investment income under section 804(b). For other rules relating to the filing of consolidated returns, see sections 1501 through 1504 and the regulations thereunder.

[T.D. 7469, 42 FR 12181, Mar. 3, 1977]

§ 1.819–1 Taxable years affected.

Section 1.819–2 is applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code, are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2791, Apr. 4, 1961]

§ 1.819–2 Foreign life insurance companies.

(a) *Carrying on United States insurance business.* Section 819(a) provides that a foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable on its United States business under section 802 in the same manner as a domestic life insurance company. Thus, the life insurance company taxable income of such a foreign life insurance company shall not be determined in the manner provided by part I, subchapter N, chapter 1 of the Code (relating to determination of sources of income), but shall be determined in the manner provided by part I, subchapter L, chapter 1 of the Code (relating to life insurance companies). See section 842. Accordingly, in determining its life insurance company taxable income from its United States business, such a foreign life insurance company shall take into account the appropriate items of income irrespective of whether such items of income are from sources within or without the United States. A foreign life insurance company shall take into account the appropriate items of expenses, losses, and other deductions properly allocable to such items of income from its United States business. To the extent not inconsistent with the provisions of this paragraph, section 818(a), and section 819(b), all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(b) *Adjustment where surplus held in the United States is less than specified minimum*—(1) *In general.* Section 819(b)(1) provides that if the minimum figure for the taxable year determined under section 819(b)(2) and subparagraph (2)(i) of this paragraph exceeds the surplus held in the United States as of the end of the taxable year (as defined in section 819(b)(2)(B) and subparagraph (2)(ii) of this paragraph) by a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, then:

(i) The amount of the policy and other contract liability requirements (determined under section 805 and § 1.805–4 without regard to this subparagraph), and

(ii) The amount of the required interest (determined under section 809(a)(2) and paragraph (d) of § 1.809–2 without regard to this subparagraph),

shall each be reduced by an amount determined by multiplying such excess by the current earnings rate (as defined in section 805(b)(2) and paragraph (a)(2) of § 1.805–5) of such company. Such current earnings rate shall be determined by reference to the assets held by the company in the United States.

(2) *Definitions.* For purposes of section 819(b)(1) and subparagraph (1) of this paragraph:

(i) The term *minimum figure*, in the case of a taxable year beginning after December 31, 1957, but before January 1, 1959, means the amount obtained by multiplying the company's total insurance liabilities on United States business by 9 percent. In the case of any taxable year beginning after December 31, 1958, such term means the amount obtained by multiplying the company's total insurance liabilities on United States business by the percentage determined and proclaimed by the Secretary as being applicable for such year.

(ii) The term *surplus held in the United States* means the excess of the assets held in the United States (as of the end of the taxable year) over the total insurance liabilities on United States business (as of the end of the taxable year).

(iii) The term *total insurance liabilities* means the sum of the total reserves (as defined in section 801(c) and paragraph (a) of § 1.801–5) as of the end of the taxable year plus (to the extent not included in total reserves) the items referred to in section 810(c) (3), (4), and (5) of paragraph (b) (3), (4), and (5) of § 1.810–2 as of the end of the taxable year; and

(iv) The term *assets* shall have the same meaning as that contained in section 805(b)(4) and paragraph (a)(4) of § 1.805–5.

(3) *Illustration of principles.* The provisions of section 819(b) and this paragraph may be illustrated by the following example:

Example. For the taxable year 1958, P, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has total insurance liabilities on United States business (as of the end of the taxable year) of $940,000, assets held in the United States of $1,000,000 (as of the end of the taxable year), policy and other contract liability requirements in the amount of $30,000 required interest in the amount of $20,000, and a current earnings rate of 4 percent. In order to determine whether section 819(b) applies for the taxable year 1958, P must first compute its minimum figure, for if the minimum figure is less than the surplus held in the United States (as of the end of the taxable year), no section 819(b) adjustments need be made. Since the minimum figure, $84,600 ($940,000, the total insurance liabilities on United States business multiplied by 9 percent, the percentage applicable for 1958), exceeds the surplus held in the United States, $60,000 (the excess of the assets held in the United States, $1,000,000, over the total insurance liabilities on United States business, $940,000), by $24,600, section 819(b) applies for the taxable year 1958. Thus, the amount of the policy and other contract liability requirements, $30,000, and the amount of the required interest, $20,000, shall each be reduced by $984 ($24,600, the amount of such excess, multiplied by 4 percent, the current earnings rate).

(4) *Segregated asset accounts.* For taxable years beginning after December 31, 1967, pursuant to the provisions of section 801(g):

(i) A foreign corporation carrying on a life insurance business which issues contracts based on segregated asset accounts shall separately compute in a manner consistent with this subparagraph the adjustment (if any) under section 819 to the amount of policy and other contract liability requirements and the amount of required interest properly attributable to each of such segregated asset accounts. The ''minimum figure'' used in section 819 in making the adjustment with respect to each of the segregated asset accounts shall be computed as provided in subdivision (ii) of this subparagraph in lieu of the manner provided in subparagraphs (1), (2), and (3) of this paragraph.

(ii) The minimum figure applicable to a segregated asset account referred to in subdivision (i) of this subparagraph is the amount determined by multiplying the total insurance liabilities on U.S. business attributable to such a segregated asset account, by 1 percent.

(iii) The minimum figure as computed under subdivision (ii) of this subparagraph shall be compared only with the surplus held in the United States attributable to each segregated asset account referred to in subdivision (i) of this subparagraph. Such surplus is the excess of assets held in the United States properly attributable to such segregated asset account over the total insurance liabilities on U.S. business properly attributable to such account.

(iv) If the minimum figure applicable to accounts other than segregated asset accounts exceeds the surplus held in the United States attributable to such other accounts, for purposes of section 819 and this paragraph, the amount of such excess shall not exceed the company's overall excess, as defined in this subdivision. No adjustment under section 819 or this paragraph shall be made with respect to any account if there is no such overall excess. For purposes of this subdivision and of subdivision (v) of this subparagraph, the term ''overall excess'' means the amount, if any, by which the aggregate minimum figures applicable to segregated asset accounts plus the minimum figure applicable to accounts other than segregated asset accounts exceeds the surplus held in the United States with respect to the company's entire U.S. life insurance business, including segregated asset accounts as well as other accounts.

(v) In the case of a company which issues contracts based on one or more than one segregated asset account, if the minimum figure applicable to a segregated asset account exceeds the surplus held in the United States attributable to such account, then for purposes of section 819 and this paragraph, the amount of such excess shall not exceed the account limitation figure, as defined in this subdivision. Therefore, no adjustment under section 819 or under this subparagraph shall be made with respect to any segregated asset account if the aggregate of the account limitation figures is zero, but nothing in this subdivision shall preclude an adjustment under section 819 with respect to accounts other than segregated asset accounts. For purposes of this subdivision, the term ''account limitation figure'' is a segregated assets account's proportionate share of the aggregate of the account limitation figures. Such aggregate of the account limitation figures is equal to the lesser of either the company's overall excess as defined in subdivision (iv) of this subparagraph, or the amount, if any, by which the aggregate of the minimum figures applicable to segregated asset accounts exceeds the surplus held in the United States with respect to all such segregated asset accounts. For purposes of this subdivision, a segregated asset account's proportionate share of the aggregate of the account limitation figures is determined by multiplying the amount of such aggregate of account limitation figures by a percentage, the numerator of which is the amount by which the minimum figure applicable to such account exceeds the surplus held in the United States attributable to such account, and the denominator of which is the aggregate of the amounts by which the minimum figure applicable to each segregated asset account exceeds the surplus held in the United States attributable to such account.

(vi) Subdivisions (i), (ii), (iii), (iv), and (v) of this subparagraph may be illustrated by the following examples:

Example 1. (a) For the taxable year 1968, T, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has the following assets and total insurance liabilities with respect to such U.S. business:

	Regular account	Separate account A	Separate account B
Assets	$9,300,000	$1,810,000	$515,000
Total insurance liabilities	8,000,000	1,800,000	500,000

It is further assumed that the percentage determined and proclaimed by the Secretary under section 819(a)(2)(A) for the taxable year 1968 is 15 percent.

(b) In order to determine whether any adjustment under section 819 must be made, T must compute the minimum figure applicable to its Regular Account as well as each of its Separate Accounts. The minimum figure for the Regular Account is $1,200,000 (15 percent of $8,000,000). The minimum figure applicable to Separate Account A is $18,000 (1 percent of $1,800,000). The minimum figure applicable to Separate Account B is $5,000 (1 percent of $500,000). The aggregate of the minimum figures is $1,223,000 ($1,200,000+$18,000+$5,000). The surplus held in the United States with respect to the Regular Account is $1,300,000 ($9,300,000 − $8,000,000), with respect to Separate Account A is $10,000 ($1,810,000 − $1,800,000) and with respect to Separate Account B is $15,000 ($515,000 − $500,000). The surplus held in the United States with respect to T's entire U.S. life insurance business is $1,325,000 ($1,300,000+$10,000+$15,000).

(c) Since the aggregate of the minimum figures ($1,223,000) does not exceed the surplus held in the United States attributable to T's entire U.S. life insurance business ($1,325,000), under subdivision (iv) of this subparagraph no adjustment under section 819 shall be made with respect to the Regular Account or either of the Separate Accounts.

Example 2. (a) The facts are the same as in example 1 except that the assets held in the United States with respect to the Regular Account is $8,300,000 instead of $9,300,000. Thus, the surplus held in the United States with respect to the Regular Account is $300,000 ($8,300,000 − $8,000,000), and the surplus held in the United States with respect to T's entire U.S. life insurance business is $325,000 ($300,000+$10,000 +$15,000).

(b) Since the aggregate of the minimum figures with respect to the Separate Accounts, $23,000 ($18,000+$5,000), does not exceed the surplus held in the United States with respect to both of such Separate Accounts, $25,000 ($10,000+$15,000), under subdivision (v) of this subparagraph, no adjustment under section 819 must be made with respect to either of the Separate Accounts.

(c) The excess of the minimum figure for the Regular Account ($1,200,000) over the surplus held in the United States with respect to the Regular Account ($300,000) is equal to $900,000 ($1,200,000 − $300,000). However, the company's overall excess as defined in subdivision (iv) of this subparagraph, is $898,000 ($1,223,000 − $325,000). Under subdivision (iv) of this subparagraph the excess with respect to the Regular Account ($900,000) is limited to the amount of overall excess ($898,000). Thus, the amount of policy and other contract liability requirements with respect to T's Regular Account and the amount of required interest with respect to T's Regular Account (both computed without regard to section 819) shall each be reduced by an amount equal to the product of $898,000 and the current earnings rate computed only with respect to T's Regular Account.

(c) *Distributions to shareholders*—(1) *In general.* In the case of a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, section 819(c)(1) provides alternative methods for determining the amount of distributions to shareholders for purposes of section 815 (relating to distributions to shareholders) and section 802(b)(3) (relating to life insurance company taxable income). Such a foreign life insurance company may elect (in the manner provided by subparagraph (4) of this paragraph) for each taxable year whichever of the alternative methods provided by section 819(c)(1) and this subparagraph it desires, and the method elected for any one taxable year shall be effective only with respect to the taxable year for which the election is made. Such alternative methods are:

(i) The amount of the distributions to shareholders shall be the amount determined by multiplying the total amount of distributions to shareholders by the percentage which the minimum figure for the taxable year is of the excess of the assets of the company over the total insurance liabilities; or

(ii) The amount of the distributions for shareholders shall be the amount determined by multiplying the total amount of distributions for shareholders by the percentage which the total insurance liabilities on United States business for the taxable year is of the total insurance liabilities of the company.

(2) *Definitions.* For purposes of section 819(c)(1) and subparagraph (1) of this paragraph:

(i) The term *total amount of the distributions to shareholders* means all distributions (within the meaning of section 815 and § 1.815–2) by a foreign life insurance company to all of its shareholders whether or not in the United States;

(ii) The term *minimum figure for the taxable year* means the amount determined under section 819(b)(2)(A) and paragraph (b)(2) of this section;

(iii) The term *assets of the company* means all of the assets (as defined in section 805(b) (4) and paragraph (a) (4) of § 1.805–5) of the foreign life insurance company whether or not in the United States (as of the end of the taxable year); and

(iv) The term *total insurance liabilities of the company* means the total insurance liabilities (as defined in section 819(b)(2) and paragraph (b)(2) of this section) on all of its business whether or not in the United States (as of the end of the taxable year).

(3) *Illustration of principles.* The provisions of section 819(c)(1) and subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. For the taxable year 1958, T, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has a minimum figure of $40,000, total amount of distributions to all shareholders (within the meaning of section 815) of $5,000, assets (as of the end of the year) of $500,000, total insurance liabilities (as of the end of the year) of $450,000, and total insurance liabilities on United States business (as of the end of the year) of $180,000. Based upon these facts, if T elects the method provided in section 819(c)(1)(A) and subparagraph (1)(i) of this paragraph, the amount of T's distributions to shareholders for the taxable year 1958 is $4,000, that is, $5,000 (the total amount of distributions to shareholders) multiplied by 80 percent (the percentage which the minimum figure for the taxable year, $40,000, is of $50,000, the excess of the assets of the company ($500,000) over the total insurance liabilities ($450,000)).

Example 2. The facts are the same as in example 1, except that for the taxable year 1958, T elects the method provided in section 819(c)(1)(B) and subparagraph (1)(ii) of this paragraph. Based upon these facts, the amount of T's distributions to shareholders for the taxable year 1958 is $2,000, that is, $5,000 (the total amount of distributions to shareholders) multiplied by 40 percent (the percentage which the total insurance liabilities on United States business ($180,000) is of the total insurance liabilities of the company ($450,000)).

(4) *Manner and effect of election.* (i) The election provided by section 819(c)(1) shall be made in a statement attached to the foreign life insurance company's income tax return for any taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. The statement shall indicate the method elected, the name and address of the taxpayer, and shall be signed by the taxpayer (or his duly authorized representative).

(ii) An election made under section 819(c)(1) and this paragraph shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which it desires the election to apply. Once such election has been made for any taxable year it may not be revoked. However, for taxable years beginning prior to April 4, 1961, a company may revoke the election provided by section 819(c)(1) without obtaining consent from the Commissioner by filing, before July 4, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation and the selection of the other percentage must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(5) *Application of section 815.* Once the amount of distributions to shareholders is determined under the provisions of section 819(c)(1) and this paragraph, the rules of section 815 (relating to distributions to shareholders) shall apply to the shareholders surplus account and the policyholders surplus account of a foreign stock life insurance company in the same manner as they would apply to a domestic stock life insurance company.

(d) *Distributions pursuant to certain mutualizations.* Section 819(c)(2) provides that for purposes of applying section 815(e) and paragraph (e) of § 1.815–6 (relating to a special rule for certain mutualizations) in the case of a foreign life insurance company subject to tax under section 802:

(1) The paid-in capital and paid-in surplus referred to in section 815(e)(1)(A) of a foreign life insurance company is the portion of such capital and surplus determined by multiplying

such amounts by the percentage selected for the taxable year under section 819(c)(1) and paragraph (c)(1) of this section; and

(2) The excess referred to in section 815(e)(2)(A)(i) (without the adjustment provided by section 815(e)(2)(B)), is whichever of the following is the greater:

(i) The minimum figure for 1958 determined under section 819(b)(2)(A); or

(ii) The surplus held in the United States (as defined in section 819(b)(2)(B)) determined as of December 31, 1958.

(e) *No United States insurance business.* Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under part I, subchapter L, chapter 1 of the Code, but shall be taxable as other foreign corporations. See section 881 and the regulations thereunder.

[T.D. 6558, 26 FR 2791, Apr. 4, 1961; 26 FR 3276, Apr. 18, 1961, as amended by T.D. 6970, 33 FR 12044, Aug. 24, 1968]

EDITORIAL NOTE: For a determination with respect to the percentage to be used by foreign life insurance companies in computing income tax for the taxable year 1984 and the estimated tax for taxable year 1985, see 51 FR 883, Jan. 9, 1986.

MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE AND CERTAIN MARINE INSURANCE COMPANIES AND OTHER THAN FIRE OR FLOOD INSURANCE COMPANIES WHICH OPERATE ON BASIS OF PERPETUAL POLICIES OR PREMIUM DEPOSITS)

§ 1.821–1 Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 831.

(a) *In general.* (1) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 801 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 821 (a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821(a)(2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822(d)(2) and § 1.822–3.

(3) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821 (a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821 (a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with

gross amounts of income from interest, dividends, rents, and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821(a)(1) or section 821(a)(2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821(b).

(b) *Rates of tax.* (1) The normal tax under section 821(a)(1)(A) and 821(b)(1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821(a)(1)(B) and 821(b)(2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821(a)(2), except as hereinafter indicated, is 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) Under section 821(a)(1)(A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of $3,000. The rate applicable in computing the normal tax of such companies is 60 percent. Under section 821(a)(2) companies with gross amounts of income from interest dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) Under section 821(b)(1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821(b)(2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821(c) provides for an adjustment of the amount computed under section 821(a)(1), section 821(a)(2), and section 821(b) where the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) *Application.* The application of section 821 (a) to (c) inclusive, may be illustrated by the following examples:

Example 1. The W Company, a mutual casualty insurance company, for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from interest, dividends, rents and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821(a)(1) for the calendar year 1954 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1954 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821(a)(1)(A) is the normal tax of $1,020. The tax under section 821(a)(2) is 2 percent of $75,000 ($150,000−$75,000), or $1,500. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821 is $1,500, namely, that imposed by section 821(a)(2).

Example 2. If in example 1 the income for purposes of the normal tax were not over $3,000, the income for purposes of the surtax were not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, were $70,000, the W Company would be required to file an income tax return but due to section 821(a) no income tax would be imposed.

Example 3. The X Company, a mutual casualty insurance company, for the calendar year 1954 has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821(a)(1) its normal tax for the calendar year 1954 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000−$25,000), or $660. The combined tax under section 821(a)(1) is $7,560 ($6,900 plus $660). The tax under section 821(a)(2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821(a) is $12,000, namely, that imposed by section 821(a)(2).

Example 4. The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received from interest, dividends, rents and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821(a)(1), without application of section 821(c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821(c), since the gross receipts are between $75,000 and $125,000. The tax under section 821(a)(1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821(a)(2), without reference to section 821(c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821(c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821(a)(1), as adjusted, exceeds $450, the tax under section 821(a)(2), as adjusted, the tax under section 821(a)(1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal taxing and surtax of $10,080.

Example 5. The Z Exchange, an interinsurer, for the calendar year 1954 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821(b)(1) for the calendar year 1954 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821(a)(2), and is not entitled to the adjustment provided in section 821(c), its total tax under section 821(a) is $3,300.

§ 1.821–2 Taxable years affected.

Section 1.821–1 is applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Section 1.821–3 is applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.821–4 and 1.821–5 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to sections of the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6681, 28 FR 11110, Oct. 17, 1963]

§ 1.821–3 Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 831.

(a) *In general.* (1) For taxable years beginning after December 31, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 802 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 821 (a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821(a)(2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822(d)(2) and § 1.822–7. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the deduction for wholly tax-exempt interest. See section 103. In the case of any such evidence of indebtedness, adjustment shall be made to basis in the same manner as that made by life insurance companies under section 1016(a)(17) and the regulations thereunder.

(3) All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821 (a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821 (a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with gross amounts of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821(a)(1) or section 821(a)(2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821(b).

(b) *Rates of tax.* (1) For taxable years beginning before July 1, 1963, the normal tax under section 821(a)(1)(A) and 821(b)(1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821(a)(1)(B) and 821(b)(2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for the purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821(a)(2), except as hereinafter indicated, is 1 percent of the gross amount of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) For taxable years beginning before July 1, 1963, under section 821(a)(1)(A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of $3,000. The

rate applicable in computing the normal tax of such companies is 60 percent. Under section 821(a)(2) companies with gross amounts of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) For taxable years beginning before July 1, 1963, under section 821(b)(1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821(b)(2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821(c) provides for an adjustment of the amount computed under section 821(a)(1), section 821(a)(2), and section 821(b) where the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) *Application.* The application of section 821 (a) to (c) inclusive, may be illustrated by the following examples:

Example 1. The W Company, a mutual casualty insurance company, for the calendar year 1958, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821(a)(1) for the calendar year 1958 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1958 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821(a)(1)(A) is the normal tax of $1,020. The tax under section 821(a)(2) is 2 percent of $75,000 ($150,000 − $75,000), or $1,500. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821 is $1,500, namely, that imposed by section 821(a)(2).

Example 2. If in the above example the income for purposes of the normal tax were not over $3,000, the income for purposes of the surtax were not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest were $70,000, the W Company would be required to file an income tax return but due to section 821(a) no income tax would be imposed.

Example 3. The X Company, a mutual casualty insurance company, for the calendar year 1958, has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821(a)(1) its normal tax for the calendar year 1958 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000 − $25,000), or $660. The combined tax under section 821(a)(1) is $7,560 ($6,900 plus $660). The tax under section 821(a)(2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821(a) is $12,000, namely, that imposed by section 821(a)(2).

Example 4. The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1958, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821(a)(1), without application of section 821(c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821(c), since the gross receipts are between $75,000 and $125,000. The tax under section 821(a)(1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821(a)(2), without reference to section 821(c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821(c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821(a)(1), as adjusted, exceeds $450, the tax under section 821(a)(2), as adjusted, the tax under section 821(a)(1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $10,080.

Example 5. The Z Exchange, an interinsurer, for the calendar year 1958 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821(b)(1) for the calendar year 1958 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821(a)(2), and is not entitled to the adjustment provided in section 821(c), its total tax under section 821(b) is $3,300.

[T.D. 6610, 27 FR 8718, Aug. 31, 1962]

§ 1.821–4 Tax on mutual insurance companies other than life insurance companies and other than fire, flood, or marine insurance companies, subject to tax imposed by section 831.

(a) *In general*—(1) *Tax imposed.* (i) For taxable years beginning after December 31, 1962, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 802 or 831, and not specifically exempt under the provisions of section 501(c)(15), are subject either to the tax imposed by section 821(a) on mutual insurance company taxable income or, in the case of certain small companies, to the tax imposed by section 821(c) on taxable investment income. The determination of whether a mutual insurance company is taxable under section 821 (a) or (c) for the taxable year is dependent upon the gross amount received by the company during such taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments). If such gross amount received exceeds $150,000, but does not exceed $500,000 for the taxable year, the company is subject to the tax imposed by section 821(c) on taxable investment income, unless (*a*) the company elects under section 821(d) in the manner provided in paragraph (f) of this section to be subject to the tax imposed by section 821(a), or (*b*) there is a balance in its protection against loss account at the beginning of the taxable year. A company having a gross amount received in excess of $500,000 is subject to the tax imposed by section 821(a). For exemption from income tax of companies having a gross amount received not in excess of $150,000, see section 501(c)(15). For the alternative tax, in lieu of the tax imposed by section 821 (a) or (c), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder. For the definition of an insurance company, see paragraph (a) of § 1.801–3.

(ii) The term ''premiums'' as used in section 821 and this section has the same meaning as in section 501(c)(15) and § 1.501(c)(15)–1, and means the total amount of the premiums and other consideration provided in the insurance contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction), but does not include amounts received from other insurance companies for losses paid under reinsurance contracts.

(2) *Tax base.* The taxable income of mutual insurance companies taxable under section 821 differs from the taxable income of other corporations. See sections 821(b) and 822. Mutual insurance companies have special items of income and special deductions not provided for other corporations. See, for example, sections 821(b)(1)(C), 822(d), 823(b), 824(a), and 825(a). Thus, the computation of mutual insurance company taxable income for a company taxable under section 821(a), and the computation of taxable investment income for a company taxable under section 821(c), must be made in strict accordance with the provisions of part II of subchapter L of the Code.

(3) *Applicability of other provisions.* All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of part II of subchapter L of the Code are applicable to the assessment and collection of the tax imposed by section 821 (a) or (c), and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) *Certain foreign companies.* Foreign mutual insurance companies (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States are not taxable under section 821 (a) or (c), but are taxable as other foreign corporations. See section 881.

(b) *Rates of tax imposed by section 821(a)*—(1) *Normal tax.* For taxable years beginning before January 1, 1964, the normal tax imposed under section 821(a) is the lesser of 30 percent of mutual insurance company taxable income, or 60 percent of the amount by which mutual insurance company taxable income exceeds $6,000. In the case of taxable years beginning after December 31, 1963, the normal tax is imposed at the rate of 22 percent of mutual insurance company taxable income, or 44 percent of the amount by which mutual insurance company taxable income exceeds $6,000, whichever is the lesser. For example, a company subject to tax under section 821(a) will file a return but will pay no normal tax if mutual insurance company taxable income does not exceed $6,000. When mutual insurance company taxable income exceeds $6,000 but does not exceed $12,000, the company will pay a normal tax equal to 44 percent (60 percent in the case of taxable years beginning before Jan. 1, 1964), of the amount by which mutual insurance company taxable income exceeds $6,000. When mutual insurance company taxable income exceeds $12,000, the company will pay normal tax at the rate of 22 percent (30 percent in the case of taxable years beginning before Jan. 1, 1964), of such income.

(2) *Surtax*—(i) *Taxable years beginning before January 1, 1964.* For taxable years beginning before January 1, 1964, companies taxable under section 821(a) are subject to a surtax equal to 22 percent of so much of their mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) as exceeds $25,000. In the case of an interinsurer or reciprocal underwriter electing to be subject to the limitation provided in section 826(b), the surtax applies to any increase in mutual insurance company taxable income attributable to such election, without regard to the $25,000 surtax exemption otherwise provided by this subparagraph, and without regard to whether the company is liable for any normal tax under subparagraph (1) of this paragraph. See section 826(f) and § 1.826–2.

(ii) *Taxable years beginning after December 31, 1963.* For taxable years beginning after December 31, 1963, companies taxable under section 821(a) are subject to a surtax at the rates and with the exemptions provided in section 11(c) on their mutual insurance company taxable income. In the case of an interinsurer or reciprocal underwriter electing to be subject to the limitation provided in section 826(b), the surtax applies to any increase in mutual insurance company taxable income attributable to such election, without regard to the surtax exemption otherwise provided by section 11(d), and without regard to whether the company is liable for any normal tax under section 821(a)(1) and subparagraph (1) of this paragraph. See section 826(f) and §1.826–2.

(c) *Mutual insurance company taxable income defined.* The tax imposed by section 821(a) with respect to any taxable year is computed upon mutual insurance company taxable income for the taxable year. Section 821(b) provides that in the case of a mutual insurance company subject to the tax imposed by section 821(a), mutual insurance company taxable income means the amount by which:

(1) The sum of:

(i) The taxable investment income (as defined in section 822(a)(1) and paragraph (a)(1) of §1.822–8).

(ii) The statutory underwriting income (as defined in section 823(a)(1) and paragraph (b)(1) of §1.823–6), and

(iii) The amounts required by section 824(d) and paragraph (b)(3) of §1.824–1 to be subtracted from the protection against loss account, exceeds.

(2) The sum of:

(i) The investment loss (as defined in section 822(a)(2) and paragraph (a)(2) of §1.822–8),

(ii) The statutory underwriting loss (as defined in section 823(a)(2) and paragraph (b)(2) of §1.823–6), and

(iii) The unused loss deduction provided by section 825(a) and paragraph (a) of §1.825–1.

If for any taxable year the amount determined under subparagraph (2) of this paragraph equals or exceeds the amount determined under subparagraph (1) of this paragraph, the mutual insurance company taxable income for such year shall be zero.

(d) *Examples.* The application of the tax imposed by section 821(a) may be illustrated by the following examples:

Example 1. (a) M, a mutual casualty insurance company, for the calendar year 1963 has gross receipts from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) in excess of $500,000, and therefore is subject to the tax imposed by section 821(a). M's taxable investment income, computed under section 822, is $30,000 and its statutory underwriting income, computed under section 823, is $15,000. M subtracts $3,000 from its protection against loss account in accordance with the computation made under section 824(d). M has no unused loss deduction. M received no partially tax exempt interest. If M is not subject to section 826, its mutual insurance company taxable income for the taxable year 1963 is $48,000, computed as follows:

(1) Taxable investment income	$30,000
(2) Statutory underwriting income	15,000
(3) Subtractions from protection against loss account	3,000
(4) Total income items	48,000
(5) Investment loss	0
(6) Statutory underwriting loss	0
(7) Unused loss deduction	0
(8) Total loss items	0
(9) Mutual insurance company taxable income (item (4) minus item (8))	48,000

(b) Since M's mutual insurance company taxable income is in excess of $12,000, M will pay normal tax on its mutual insurance company taxable income at a rate of 30 percent. In addition, since M's mutual insurance company taxable income exceeds $25,000, M will pay surtax on such excess at a rate of 22 percent. M's total tax liability for the taxable year 1963 is $19,460, computed as follows:

(1) Mutual insurance company taxable income as computed in item (a)(9)	$48,000
(2) Normal tax; 30 percent of mutual insurance company taxable income	14,400
(3) Surtax exemption	25,000
(4) Mutual insurance company taxable income subject to the surtax (item (1) minus item (3))	23,000
(5) Surtax: 22 percent of mutual insurance company taxable income subject to the surtax	5,060
(6) Total tax (item (2) plus item (5))	19,460

Example 2. If in example 1, M's mutual insurance company taxable income for 1963 had been in excess of $6,000 but not in excess of $12,000, M would pay normal tax in an

amount equal to 60 percent of the amount by which such income exceeded $6,000. Thus, if M had mutual insurance company taxable income of $11,000, M's total tax liability for the taxable year 1963 would be $3,000, computed as follows:

(1) Mutual insurance company taxable income	$11,000
(2) Mutual insurance company taxable income in excess of $6,000 ($11,000 minus $6,000)	5,000
(3) 30 percent of item (1)	3,800
(4) 60 percent of item (2)	3,000
(5) Normal tax (lesser of items (3) or (4))	3,000
(6) Surtax exemption	25,000

Since the surtax exemption exceeds the mutual insurance company taxable income for purposes of the surtax, there is no surtax liability. Since the normal tax under section 821(a) is the lesser of 30 percent of mutual insurance company taxable income or 60 percent of the amount by which such income exceeds $6,000, M's normal tax (and total income tax liability) is $3,000. If M's mutual insurance company taxable income was not in excess of $6,000, M would be required to file a return, but would not be liable for any normal tax, since, in such a case, 60 percent of M's mutual insurance company taxable income in excess of $6,000 would be zero.

Example 3. Assume the same income as in example 1 in the 1965 calendar year and that M is not a corporation to which section 1561 (with respect to certain controlled corporations) applies. Since M's mutual insurance company taxable income is in excess of $12,000, M will pay normal tax on its mutual insurance company taxable income at a rate of 22 percent. In addition, since M's mutual insurance company taxable income exceeds the surtax exemption provided in section 11(d) of $25,000, M will pay a surtax on such excess at the rate provided in section 11(c), 26 percent. M's total liability for the taxable year 1964 is $16,540, computed as follows:

(1) Mutual insurance company taxable income as computed in example (1)	$48,000
(2) Normal tax: 22 percent of mutual insurance company taxable income for normal tax purposes	10,560
(3) Surtax exemption provided by section 11(d)	25,000
(4) Mutual insurance company taxable income subject to the surtax (item (1) minus item (3))	23,000
(5) Surtax: at rates provided in section 11(c): 26 percent of mutual insurance company taxable income subject to the surtax	5,980
(6) Total tax (item (2) plus item (5))	16,540

(e) *Alternative tax for certain small mutual insurance companies*—(1) *In general.* (i) Section 821(c) provides an alternative tax for certain small mutual insurance companies. This alternative tax, which is in lieu of the tax imposed by section 821(a), is imposed on taxable investment income (as defined in section 822(a)(1) and paragraph (a)(1) of §1.822–8) and consists of a normal tax and a surtax. The tax provided by section 821(c) is imposed on every mutual insurance company (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831) which received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) a gross amount in excess of $150,000 but not in excess of $500,000, except a company which has properly elected under section 821(d) and paragraph (f) of this section to be subject to the tax imposed by section 821(a), or a company which has a balance in its protection against loss account at the beginning of the taxable year.

(ii) Any company which would be taxable under section 821(c) but for the presence of an amount in its protection against loss account at the beginning of the taxable year may elect to subtract the balance from such account. See section 824(d)(5) and §1.824–3. If such an election is made in such a case, the company shall not be subject to the tax imposed by section 821(a), but shall be subject to the tax imposed by section 821(c).

(2) *Rates of tax imposed by section 821(c)*—(i) *Normal tax.* The normal tax for taxable years beginning before January 1, 1964, is the lesser of 30 percent of taxable investment income or 60 percent of the amount by which taxable investment income exceeds $3,000. For taxable years beginning after December 31, 1963, the normal tax is imposed at the rate of 22 percent of taxable investment income, or 44 percent of the amount by which taxable investment income exceeds $3,000, whichever is the lesser. Thus, a company subject to tax under section 821(c) will file a return but will pay no tax if for the taxable year its taxable investment income does not exceed $3,000; or will pay a

normal tax equal to 44 percent (60 percent in the case of taxable years beginning before Jan. 1, 1964), of taxable investment income in excess of $3,000 when such income exceeds $3,000 but does not exceed $6,000. When taxable investment income exceeds $6,000, the normal tax is imposed at the rate of 22 percent (30 percent in the case of taxable years beginning before Jan. 1, 1964) of such income.

(ii) *Surtax.* For taxable years beginning before January 1, 1964, a surtax is imposed at the rate of 22 percent of taxable investment income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000. For taxable years beginning after December 31, 1963, a surtax is imposed at the rate provided in section 11(c) on taxable investment income in excess of the surtax exemption provided in section 11(d).

(f) *Election to be taxed under section 821(a)*—(1) *In general.* Section 821(d) provides that any mutual insurance company taxable under section 821(c) may elect, in the manner provided by subparagraph (3) of this paragraph, to be taxed under section 821(a).

(2) *Scope of election.* Except as otherwise provided herein, an election made under section 821(d) and this paragraph to be taxable under section 821(a) shall be binding for the taxable year for which made and for all succeeding taxable years unless the Commissioner consents to a revocation of such election. If for any taxable year the gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $150,000, a company's prior election made under section 821(d) to be taxable under section 821(a) will automatically terminate and any balance in the protection against loss account will be taken into account for the preceding taxable year. (See section 824(d)(4) and § 1.824–2 for automatic termination of protection against loss account if company is not subject to the tax imposed by section 821(a).) If for any taxable year thereafter the gross amount received exceeds $150,000 but does not exceed $500,000, the company shall be taxable under section 821(c) unless it makes a new election to be taxable under section 821(a). If a company subject to tax under section 821(c) for a taxable year elects under section 821(d) and this section to be taxed under section 821(a) and, in a subsequent taxable year, the gross receipts of such company exceed $500,000, the election made for such earlier taxable year shall be considered as continuing in effect. Thus, such a company will continue to be taxable under section 821(a) notwithstanding that its gross receipts subsequently fall below $500,000 (so long as they do not fall below $150,000) unless the Commissioner consents to a revocation of the prior election. Whether revocation is permissible in any case will depend on the facts and circumstances of the particular case, but in no case will revocation be granted in the absence of a showing that the election creates an undue burden or material hardship on the company due to a substantial change in the character of its operations.

(3) *Time and manner of making election.* The election provided by section 821(d) shall be made in a statement attached to the company's income tax return for the first taxable year for which the election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or its duly authorized representative), and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year.

(g) *Examples.* The application of the tax imposed by section 821(c) may be illustrated by the following examples:

Example 1. M, a mutual casualty insurance company, for the calendar year 1963 has a gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) of $400,000. Since M's gross amount received exceeds $150,000, but does not exceed $500,000, M is subject to the tax imposed by section 821(c) on taxable investment income unless it elects to be subject to the tax imposed on mutual insurance company taxable income by section 821(a). M computes its taxable investment income under section 822 to be $35,000. In computing taxable investment income, M deducted $2,000 of partially tax-exempt interest under section 242. If M does not make an election to be taxed under section 821(a), its total tax liability for the taxable year 1963 is $13,140 computed as follows:

(1) Taxable investment income as computed under section 822	$35,000
(2) 30 percent of taxable investment income	10,500
(3) 60 percent of taxable investment income in excess of $3,000	19,200
(4) Normal tax (lesser of items (2) or (3))	10,500
(5) Partially tax-exempt interest deducted in computing taxable investment income	2,000
(6) Taxable investment income for purposes of the surtax (item (1) plus item (5))	37,000
(7) Surtax exemption	25,000
(8) Taxable investment income subject to surtax (item (6) minus item (7))	12,000
(9) Surtax (22 percent of item (8))	2,640
(10) Total tax liability (item (4) plus item (9))	13,140

Example 2. N, a mutual casualty insurance company, for the taxable year 1963 has a gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) of $210,000. Since N's gross amount received exceeds $150,000 but does not exceed $500,000, N is subject to the tax imposed by section 821(c) on taxable investment income unless it elects to be subject to the tax imposed by section 821(a). Furthermore, since the gross amount received by N does not exceed $250,000, N is entitled to the special tax reduction provided by section 821(c)(2). N computes its taxable investment income under section 822 to be $24,000. In computing taxable investment income, N deducted $2,000 of partially tax-exempt interest under section 242. If N does not make an election to be taxed under section 821(a), its total tax liability for the taxable year 1963 is $4,452 computed as follows:

(1) Taxable investment income as computed under section 822	$24,000
(2) 30 percent of taxable investment income	7,200
(3) 60 percent of taxable investment income in excess of $3,000	12,600
(4) Normal tax (lesser of items (2) or (3))	7,200
(5) Partially tax-exempt interest deducted in computing taxable investment income	2,000
(6) Taxable investment income for purposes of the surtax (item (1) plus item (5))	26,000
(7) Surtax exemption	25,000
(8) Taxable investment income subject to surtax (item (6) minus item (7))	1,000
(9) Surtax 22 percent of item (8)	220
(10) Tax liability computed without regard to special reduction (item (4) plus item (9))	7,420
(11) Amount by which gross receipts exceed $150,000 ($210,000 gross receipts minus $150,000)	60,000
(12) Percentage which item (1) bears to $100,000 ($60,000 over $100,000)	0.60
(13) Tax as adjusted (percentage determined in item (12) applied to item (10))	4,452

If N's taxable investment income for purposes of the surtax did not exceed $3,000, N would file a return but would pay no tax. Had N elected (under section 821(d)) to be subject to tax under section 821(a), N would not be entitled to the special reduction afforded by section 821(c)(2), since that provision applies only to companies taxable under section 821(c).

[T.D. 6681, 28 FR 11110, Oct. 17, 1963, as amended by T.D. 7100, 36 FR 5333, Mar. 20, 1971; 36 FR 5846, Mar. 30, 1971]

§ 1.821–5 Special transitional underwriting loss.

(a) *In general.* Section 821(f) provides a special reduction in the statutory underwriting income (as defined by section 823(a)(1) and paragraph (b)(1) of § 1.823–6) of any company taxable under section 821(a) which was taxable under section 821 for the five taxable years immediately preceding January 1, 1962, and which incurred an underwriting loss (as defined in section 821(f)(3) and paragraph (c) of this section) for each of such five taxable years.

(b) *Amount of reduction.* In the case of a company described in section 821(f)(1) and paragraph (a) of this section the statutory underwriting income for the taxable year (determined without regard to this paragraph) shall be reduced by an amount equal to the amount by which:

(1) The sum of the underwriting losses of such company for the five taxable years immediately preceding January 1, 1962, exceeds

(2) The total amount by which the company's statutory underwriting income was reduced by reason of section 821(f) and this section for prior taxable years.

(c) *Underwriting loss defined.* For purposes of computing the amount of the reduction available under section 821(f) and paragraph (a) of this section, the term underwriting loss means statutory underwriting loss (as defined by section 823(a)(2) and paragraph (b)(2) of § 1.823–6) computed without any deduction under section 824(a) and paragraph (a) of § 1.824–1 (relating to deduction to provide protection against losses) and without any deduction under section 832(c)(11) (relating to dividends and similar distributions paid or declared to policyholders). For rules relating to the definition of dividends and similar distributions paid or declared to policyholders, see paragraph (a) of § 1.832–5.

(d) *Years of applicability.* Section 821(f)(4) provides that the special reduction of statutory underwriting income allowed by section 821(f)(2) and paragraph (b) of this section shall apply to any taxable year beginning after December 31, 1962, and before January 1, 1968, for which the taxpayer is subject to the tax imposed by section 821(a).

[T.D. 6681, 28 FR 11112, Oct. 17, 1963]

§ 1.822–1 Taxable income and deductions.

(a) *In general.* For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, the taxable income of a mutual insurance company subject to the tax imposed by section 821 is its gross investment income, namely, the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets, less the deductions provided in section 822(c) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses to the extent provided in subchapter P (sec. 1201 and following), chapter 1 of the Code, and the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(c) *Investment expenses.* The deduction allowed by section 822(c)(2) for investment expenses is the same as that allowed life insurance companies by section 803(g)(2). See paragraph (c) of § 1.803–4.

(d) *Taxes and expenses with respect to real estate.* The deduction allowed by section 822(c)(3) for taxes and expenses with respect to real estate owned by the company is the same as that allowed life insurance companies by section 803(g)(3). See paragraph (d) of § 1.803–4.

(e) *Depreciation.* The deduction allowed by section 822(c)(4) for depreciation is the same as that allowed life insurance companies by section 803(g)(4). See paragraph (e) of § 1.803–4.

(f) *Interest paid or accrued.* The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(g) *Capital losses.* (1) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(2) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of interest, dividends, rents, and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital

losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(3) The application of section 822(c)(6) may be illustrated by the following examples:

Example 1. The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1954 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, rents of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example 2. If in example 1 the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example 3. If in example 1 the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1954, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(h) *Special deductions.* Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received.

§ 1.822–2 Real estate owned and occupied.

The limitation in section 822(d)(1) on the amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 is the same as that provided in the case of life insurance companies by section 803(h). See § 1.803–5.

§ 1.822–3 Amortization of premium and accrual of discount.

Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 803(i) and shall be determined in accordance with § 1.803–6, except that in determining the premium and discount of a mutual insurance company subject to the tax imposed by section 821 the basis provided in section 1012 shall be used in lieu of the acquisition value.

§ 1.822–4 Taxable years affected.

Sections 1.822–1 through 1.822–3 are applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.822–5 through 1.822–7 are applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.822–8 through 1.822–12 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6681, 28 FR 11113, Oct. 17, 1963]

§ 1.822–5 Mutual insurance company taxable income.

(a) *Mutual insurance company taxable income defined.* Section 822(a) defines the term ''mutual insurance company taxable income'' for purposes of part II, subchapter L, chapter 1 of the Code. Mutual insurance company taxable income means gross investment income (as defined in section 822(b) and paragraph (b) of this section), less the deductions provided in section 822(c) and paragraph (c) of this section for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses, special deductions, trade or business (other than in insurance business) expenses, and depletion. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code. For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172, and a deduction shall not be permitted with respect to the same item more than once.

(b) *Gross investment income defined.* For purposes of part II, subchapter L, chapter 1 of the Code, section 822(b) defines the term ''gross investment income'' of a mutual insurance company subject to the tax imposed by section 821 as the sum of the following:

(1) The gross amount of income during the taxable year from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–7;

(ii) Dividends, as described in § 1.61–9;

(iii) Rents and royalties, as described in § 1.61–8;

(iv) The entering into of any lease, mortgage or other instrument or agreement from which the company may derive interest, rents, or royalties;

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph;

(vi) Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses), chapter 1 of the Code.

(2) The gross income from any trade or business (other than an insurance business) carried on by a mutual insurance company subject to the tax imposed by section 821, or by a partnership of which the insurance company is a partner.

For example, gross investment income includes amounts received as commitment fees, or as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage. In computing the gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner, any item described in section 822(b)(1) and paragraph (b)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) and paragraph (b)(1) of this section.

(c) *Deductions from gross investment income*—(1) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(2) *Investment expenses.* (i) The deduction for investment expenses under section 822(c)(2) includes only those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a mutual insurance company subject to the tax imposed by section 821 subjects the entire deduction for investment expenses to the limitation provided in section 822(c)(2) and subdivision (iii) of this subparagraph. As used in section 822(c)(2), the term ''general expenses'' means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expense is allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 822(c)(2) and subdivision (iii) of this subparagraph. However, a company subject to the tax imposed by section 821 shall not deduct under section 822(c)(2) its real estate taxes, depreciation, or other expenses with respect to any portion of the real estate which it owns, irrespective of whether such items are properly allocable to its investment department. For the rules relating to the deductibility of these items, see section 822(c) (3) and (4) and subparagraphs (3) and (4) of this paragraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 822(c)(2) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any.

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 822(c)(2) shall not exceed the sum of:

(a) One-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year, plus.

(b) One-fourth of the amount by which mutual insurance company taxable income (computed without any deduction for investment expenses, tax-free interest, partially tax-exempt interest, or dividends received) exceeds 33/4 percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

For purposes of section 822(c)(2) and this paragraph, the term ''invested assets'' means only those assets which are owned and used, and to the extent used, for the purpose of producing the income specified in section 822(b). See paragraph (b) of this section. The term does not include real estate owned and occupied, and to the extent owned and occupied, by the company.

(3) *Real estate expenses and taxes.* The deduction for real estate expenses and taxes under section 822(c)(3) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 822(c)(3) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 822(c)(3) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See §1.822–6 for limitation of such deduction.

(4) *Depreciation.* The deduction allowed by section 822(c)(4) for depreciation is, except as provided in section 822(d)(1) and §1.822–6, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining mutual insurance company taxable income is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 822(b).

(5) *Interest paid or accrued.* The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See §1.163–1.

(6) *Capital losses.* (i) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P, chapter 1 of the Code but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(ii) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(iii) The application of section 822(c)(6) may be illustrated by the following examples:

Example 1. The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1958 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, royalties of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example 2. If in example 1 the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example 3. If in example 1 the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, chapter 1 of the Code, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1958, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(7) *Special deductions.* Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received.

(8) *Trade or business deductions.* (i) Under section 822(c)(8), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the company is a partner are, subject to the limitations in subdivision (ii) of this subparagraph, allowable as deductions from gross investment income in computing mutual insurance company taxable income. Such deductions are allowable, however, only to the extent that they relate to income which is included in the company's gross investment income by reason of section 822(b) (2). Thus, a deduction shall not be allowed under section 822(c)(8) with respect to any item described in section 822(b)(1). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 822(c)(8):

(a) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if the company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(b) The deduction for net operating losses provided in section 172 shall not be allowed.

(9) *Depletion.* The deduction allowed by section 822(c)(9) for depletion is the same as that allowed life insurance companies under section 804(c)(4). See paragraph (b)(5) of § 1.804–4.

[T.D. 6610, 27 FR 8720, Aug. 31, 1962, as amended by T.D. 6631, 28 FR 219, Jan. 9, 1963]

§ 1.822–6 Real estate owned and occupied.

Section 822(d)(1) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.822–7 Amortization of premium and accrual of discount.

Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 818(b)(1), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 133), and shall be determined in accordance with paragraphs (a) and (b) of § 1.818–3, except in the case of a mutual insurance company subject to the tax imposed by section 821, paragraph (b) of § 1.818–3 shall apply without regard to the date of acquisition and the basis provided in section 1012 shall be used in lieu of the acquisition value.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.822–8 Determination of taxable investment income.

(a) *In general*—(1) *Taxable investment income defined.* Section 822(a)(1) defines the term ''taxable investment income'' for purposes of part II, subchapter L, chapter 1 of the Code as the gross investment income (as defined in section 822(b) and paragraph (b) of this section), less the deductions provided in section 822(c) and paragraph (c) of this section for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses, special deductions, trade or business (other than an insurance business) expenses, and depletion. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code.

For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 (a) or (c) are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172. See, however, section 825 and paragraph (a) of § 1.825–1 for unused loss deduction allowed companies taxable under section 821(a). A deduction shall not be permitted with respect to the same item more than once.

(2) *Investment loss defined.* The term ''investment loss'' is defined by section 822(a)(2) as the amount by which the deductions allowable under section 822(c) and paragraph (c) of this section exceed the gross investment income (as defined in section 822(b) and paragraph (b) of this section).

(b) *Gross investment income defined.* For purposes of part II, subchapter L, chapter 1 of the Code, section 822(b) defines the term ''gross investment income'' of a mutual insurance company subject to the tax imposed by section 821 (a) or (c) as the sum of the following:

(1) The gross amount of income during the taxable year from:

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–10;

(ii) Dividends, as described in § 1.61–9;

(iii) Rents and royalties, as described in § 1.61–8;

(iv) The entering into of any lease, mortgage or other instrument or agreement from which the company may derive interest, rents, or royalties;

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph;

(vi) Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses) chapter 1 of the Code.

(2) The gross income from any trade or business (other than an insurance business) carried on by a mutual insurance company subject to the tax imposed by section 821 (a) or (c), or by a partnership of which the insurance company is a partner.

For example, gross investment income includes amounts received as commitment fees, or as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage. In computing the gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner, any item described in section 822(b)(1) and paragraph (b)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) and paragraph (b)(1) of this section.

(c) *Deductions from gross investment income*—(1) *Wholly tax-exempt interest.* Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(2) *Investment expenses.* (i) The deduction for investment expenses under section 822(c)(2) includes only those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a mutual insurance company subject to the tax imposed by section 821 (a) or (c) subjects the entire deduction for investment expenses to the limitation provided in section 822(c)(2) and subdivision (iii) of this subparagraph. As used in section 822(c)(2), the term ''general expenses'' means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expense is allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 822(c)(2) and subdivision (iii) of this subparagraph. However, a company subject to the tax imposed by section 821 (a) or (c) shall not deduct under section 822(c)(2) its real estate taxes, depreciation, or other expenses with respect to any portion of the real estate which it owns, irrespective of whether such items are properly allocable to its investment department. For the rules relating to the deductibility of these items, see section 822(c) (3) and (4) and subparagraphs (3) and (4) of this paragraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 822(c)(2)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any.

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 822(c)(2) shall not exceed the sum of:

(a) One-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year, plus

(b) One-fourth of the amount by which taxable investment income (computed without any deduction for

investment expenses, tax-free interest, partially tax-exempt interest, or dividends received) exceeds 33/4 percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

For purposes of section 822(c)(2) and this paragraph, the term ''invested assets'' means only those assets which are owned and used, and to the extent used, for the purpose of producing the income specified in section 822(b). See paragraph (b) of this section. The term does not include real estate owned and occupied, and to the extent owned and occupied, by the company.

(3) *Real estate expenses and taxes.* The deduction for real estate expenses and taxes under section 822(c)(3) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 822(c)(3) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 822(c)(3) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See § 1.822–9 for limitation of such deduction.

(4) *Depreciation.* The deduction allowed by section 822(c)(4) for depreciation is, except as provided in section 822(d)(1) and § 1.822–9, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining taxable investment income is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 822(b).

(5) *Interest paid or accrued.* The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(6) *Capital losses.* (i) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P, chapter 1 of the Code but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(ii) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(iii) The application of section 822(c)(6) may be illustrated by the following examples:

Example 1. The X Company, a mutual fire insurance company subject to tax under section 821, in the taxable year 1963 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, royalties of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000) is $75,000. Since the gross receipts from the sale of capital assets ($60,000) do not exceed such excess

($75,000), the losses of $20,000 are allowable as a deduction from gross investment income in computing taxable investment income under section 822.

Example 2. If in example 1 the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example 3. If in example 1 the X Company had taxable investment income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, chapter 1 of the Code, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1963, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable investment income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable investment income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(7) *Special deductions.* Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received. In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subparagraph, the reference in such section to ''taxable income'' shall be treated as a reference to ''taxable investment income''.

(8) *Trade or business deductions.* (i) Under section 822(c)(8), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the company is a partner are, subject to the limitations in subdivision (ii) of this subparagraph, allowable as deductions from gross investment income in computing taxable investment income. Such deductions are allowable, however, only to the extent that they relate to income which is included in the company's gross investment income by reason of section 822(b)(2). Thus, a deduction shall not be allowed under section 822(c)(8) with respect to any item described in section 822(b)(1). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 822(c)(8):

(a) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if the company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(b) The deduction for net operating losses provided in section 172 shall not be allowed.

(9) *Depletion.* The deduction allowed by section 822(c)(9) for depletion is the same as that allowed life insurance companies under section 804(c)(4). See paragraph (b)(5) of § 1.804–4.

[T.D. 6681, 28 FR 11113, Oct. 17, 1963]

§ 1.822–9 Real estate owned and occupied.

Section 822(d)(1) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 (a) or (c) shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–10 Amortization of premium and accrual of discount.

(a) *In general.* In computing taxable investment income for the taxable year, the gross amount of income from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are, under the provisions of section 822(d)(2), each to be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821 (a) or (c). However, only the accrual of discount relating to issue discount will increase the deduction for wholly tax-exempt interest. See section 103. Such amortization and accrual is the same as that provided for life insurance companies by section 818(b)(1), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 133), and shall be determined in accordance with paragraphs (a) and (b) of § 1.818–3, except as provided by paragraph (b) of this section.

(b) *Modifications.* (1) Paragraph (b) of § 1.818–3 shall apply to mutual casualty insurance companies subject to the tax imposed by section 821 (a) or (c) without regard to the date of acquisition of the particular securities to which the amortization of premium or accrual of discount is attributable.

(2) In computing the amount of premium or discount for purposes of section 822(d)(2) with respect to securities held by a company taxable under section 821, the basis provided by section 1012 shall be used in lieu of the acquisition value provided by paragraph (b) of § 1.818–3. In the case of a company subject to the tax imposed by section 821(c), adjustments to basis to reflect the accrual of discount and the amortization of premium shall be made in the manner provided by paragraphs (a) and (b) of § 1.818–3. However, for purposes of determining statutory underwriting income or loss for the taxable year under section 823, a company subject to the tax imposed by section 821(a) is not required to accrue discount or to amortize premium in computing its income under section 832 as if it were subject to the tax imposed by section 831. Thus, the accrual of discount and amortization of premium required in the computation of taxable investment income by a company subject to the tax imposed by section 821(a) neither increases nor decreases the mutual insurance company taxable income of such a company and, except to the extent such a company actually accrues discount or amortizes premium for purposes of making the section 832 computation, no adjustment shall be made to the basis of obligations held by it to reflect accrual of discount or amortization of premium.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–11 Net premiums.

The term ''net premiums'', defined in section 822(f)(1), includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 822(f)(2). Net premiums are used in sections 822(c)(6) and 832(c)(5) in determining the limitation on certain capital losses and in the application of section 1212.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–12 Dividends to policyholders.

(a) Dividends to policyholders are used in determining the ''underwriting loss'' for purposes of the special transitional underwriting loss deduction provided by section 821(f), and the limitation on capital losses under section 822(c)(6); in computing statutory underwriting income or loss under section 823, and the subtractions from the protection against loss account under section 824(d). The term ''dividends to policyholders'' is defined in section 822(f)(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 822(f)(1). Savings credited to the individual accounts of the subscribers of a reciprocal underwriter or interinsurer under section 823(b)(2) are not dividends paid or declared within the meaning of this paragraph. However, distributions in respect of such credits shall be considered as dividends paid. See section 823(b)(2) and paragraph (c)(2) of § 1.823–6. The term ''paid or declared'' is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed by adding the amount of dividends and similar distributions declared but unpaid at the end of the taxable year to dividends and similar distributions paid during the taxable year and deducting dividends and similar distributions declared but unpaid at the beginning of the taxable year. If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.823–1 Net premiums.

Net premiums are one of the items used, together with interest, dividends, and rents, less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ''net premiums'' is defined in section 823(1) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

§ 1.823–2 Dividends to policyholders.

(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ''dividends to policyholders'' is defined in section 823(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 823(1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term ''paid or declared'' is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows:

To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year.

If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

§ 1.823–3 Taxable years affected.

Sections 1.823–1 and 1.823–2 are applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.823–4 and 1.823–5 are applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.823–6 through 1.823–8 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6681, 28 FR 11116, Oct. 17, 1963]

§ 1.823–4 Net premiums.

Net premiums are one of the items used, together with the gross amount of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof), less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ''net premiums'' is defined in section 823(1) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.823–5 Dividends to policyholders.

(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term ''dividends to policyholders'' is defined in section 823(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 823(1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term ''paid or declared'' is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows: To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year. If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.823–6 Determination of statutory underwriting income or loss.

(a) *In general.* Section 823(a) and this section provide that for purposes of determining statutory underwriting income or loss for the taxable year, a mutual insurance company subject to the tax imposed by section 821(a) must first take into account the same gross income and deduction items (except as modified by section 823(b) and paragraph (c) of this section) as a taxpayer subject to tax under section 831 would take into account for purposes of determining its taxable income under section 832. These items are then reduced to the extent that they include amounts which are included in determining taxable investment income or loss under section 822(a) and § 1.822–8. In addition, in computing its statutory underwriting income or loss for the taxable year, a company taxable under section 821(a) is allowed to deduct the amount determined under section 824(a) (relating to deduction to provide protection against losses) and, if its gross amount received is less than $1,100,000, is allowed to deduct the amount determined under section 823(c) and paragraph (d) of this section (relating to special deduction for certain small companies), subject to the limitations provided therein.

(b) *Definitions*—(1) *Statutory underwriting income defined.* Section 823(a) (1) defines the term ''statutory underwriting income'' for purposes of part II of subchapter L of the Code. Subject to the modifications provided by section 823(b) and paragraph (c) of this section, statutory underwriting income is defined as the amount by which:

(i) The gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income (as determined under section 822(b)), exceeds

(ii) The sum of:

(a) The deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c) (relating to deductions allowed in computing taxable investment income), plus

(b) The deductions provided in section 823(c) (relating to special deduction for small company having gross amount of less than $1,100,000) and section 824(a) (relating to deduction to provide protection against losses).

For purposes of subdivision (ii)*(a)* of this subparagraph, the limitations on the amounts deductible under paragraphs (9) (relating to charitable, etc., contributions) and (12) (relating to partially tax-exempt interest and to dividends received) of section 832(c) shall be computed by reference to taxable income as defined by section 832(a), and as modified by section 823(b) and paragraph (c) of this section.

(2) *Statutory underwriting loss defined.* ''Statutory underwriting loss'' is defined in section 823(a)(2) as the amount by which the amount determined under section 823(a)(1)(B) and subparagraph (1)(ii) of this paragraph exceeds the

amount determined under section 823(a)(1)(A) and subparagraph (1)(i) of this paragraph.

(c) *Modifications*—(1) *Net operating losses.* In applying section 832 for purposes of determining statutory underwriting income or loss under section 823(a) and paragraph (b) of this section, the deduction for net operating losses provided by section 172 is not allowed. However, see section 825(a) and § 1.825–1 for unused loss deduction allowed companies taxable under section 821(a) in computing mutual insurance company taxable income under section 821(b).

(2) *Interinsurers and reciprocal underwriters*—(i) *In general.* Section 823(b)(2) provides that in computing the statutory underwriting income or loss of a mutual insurance company which is an interinsurer or reciprocal underwriter, there shall be allowed as a deduction the increase for the taxable year in savings credited to subscriber accounts, or there shall be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts. For purposes of this subparagraph, the term ''savings credited to subscriber accounts'' means such portion of the surplus for the taxable year as is credited to the individual accounts of subscribers before the 16th day of the third month following the close of the taxable year, but only if the company would be obligated to pay such amount promptly to such subscriber if he terminated his contract at the close of the company's taxable year, and only if the company mails notification to such subscriber of the amount credited to his individual account in the manner provided by subdivision (v) of this subparagraph.

(ii) *Limitations.* Amounts representing return premiums (as defined in paragraph (a)(1)(ii) of § 1.809–4) which the company would be obligated to pay to any subscriber terminating his contract at the close of the company's taxable year are not savings credited to subscriber accounts within the meaning of section 823(b)(2) and subdivision (i) of this subparagraph. The deduction for savings credited to individual subscriber accounts is allowed only in the case of reciprocal underwriters or interinsurers where the subscriber or policyholder has not only a legally enforceable right to receive the amount so credited if he withdraws from the exchange, but where the amounts credited, as a matter of actual practice, are paid to subscribers or policyholders who terminate their contracts. Thus, no deduction shall be allowed for savings credited to subscriber accounts if such savings are not in fact promptly returned to subscribers when they terminate their contracts.

(iii) *Computation of increase or decrease in savings credited to subscriber accounts.* For purposes of determining the increase or decrease for the taxable year in savings credited to subscriber accounts, every reciprocal underwriter or interinsurer claiming a deduction under section 823(b)(2) and this section shall establish and maintain an account for savings credited to subscriber accounts. The opening balance in such account for the first taxable year for which a deduction is claimed under section 823(b)(2) and this section shall be zero. In each taxable year there shall be added to such account the total amount of savings credited to subscriber accounts for the taxable year, and there shall be subtracted from such account the total amount of savings subtracted from subscriber accounts for the taxable year. However, in no case may the amount added to the account exceed the total amount of savings to subscribers for the taxable year, irrespective of the amount of savings credited to subscriber accounts for the taxable year. Credits made to subscriber accounts after the close of the taxable year and before the 16th day of the third month following the close of the taxable year will be taken into account as if such amounts had been credited on the last day of the taxable year to the extent such amounts would have become fixed and determinable legal obligations due subscribers if such subscribers had terminated their contracts on the last day of the company's taxable year unless, at the time the amounts are credited, the company specifically designates such amounts as being from surplus for the taxable year in which the amounts were actually credited. Such a designation, once made, shall be irrevocable. However, if a company credited savings to subscriber accounts after December 31, 1962, and before March 16, 1963, and failed to designate such credits as being from surplus for the taxable year 1963, such company may designate such credits as being from surplus for the taxable year 1963 for purposes of determining the total amount of credits to subscriber accounts for such year. In determining the total amount of savings subtracted from subscriber accounts for the taxable year, only amounts subtracted from savings credited for taxable years beginning with the first taxable year for which a deduction was claimed under section 823(b)(2) and this subparagraph will be taken into account. The method of accounting regularly employed by the taxpayer in keeping its books of account will be used for purposes of determining whether the amounts subtracted from the subscriber accounts are from savings for taxable years beginning before the first taxable year for which a deduction is claimed under section 823(b)(2) and this subparagraph, or from savings for taxable years beginning with such first taxable year. Where the method of accounting regularly employed by the taxpayer in keeping its books of account does not clearly indicate whether an amount was subtracted from savings credited to subscriber accounts for taxable years beginning before the first taxable year for which a deduction is claimed under section 823(b)(2) and this subparagraph, or from savings credited for such first taxable year and subsequent taxable years, the amount subtracted will be deemed to have come from savings credited to subscriber accounts for all taxable years, on a pro rata basis. Where an amount is subtracted from a subscriber's account for record purposes, but such subtraction does not reflect the discharge of the company's legal obligation to pay the amount subtracted promptly to the subscriber if he terminates his contract, then such subtraction shall not be taken into account for purposes of section 823(b)(2) and this subparagraph. On the other hand, where the company ceases to be under a legal obligation to pay promptly to any subscriber the amount credited to his individual account, then such amount shall be considered as having been subtracted from such subscriber's account at the time such obligation ceased to exist. For purposes of section 823(b)(2) and this subparagraph, the increase (if any) for the taxable year in savings credited to subscriber accounts shall be the amount by which the balance in the account for savings credited to subscriber accounts as of the close of the taxable year exceeds the balance in such account as of the close of the preceding taxable year; and the decrease (if any) for the taxable year in savings credited to subscriber accounts shall be the amount by which the balance in the account for savings credited to subscriber accounts as of the close of the preceding taxable year exceeds the balance in such account as of the close of the taxable year.

(iv) *Legal obligation.* For purposes of this subparagraph, the existence of a legal obligation on the part of the company to pay to the subscriber the savings credited to him will be determined under the insurance contract pursuant to which the credits are made. Where it appears that the company is otherwise legally obligated to pay amounts credited to its subscribers, the requisite legal obligation will not be considered absent merely because a subscriber's credits remain subject to absorption by future losses incurred if left on deposit with the company.

(v) *Notification to subscribers.* Every reciprocal underwriter or interinsurer claiming a deduction under section 823(b)(2) and this subparagraph for amounts credited to the individual accounts of its subscribers must mail to each such subscriber written notification of the amount credited to the subscriber's account for the taxable year, the date on which such amount was credited, and the date on which the subscriber's right to such amount first would have become fixed if such subscriber had terminated his contract at the close of the company's taxable year. As an alternative to providing each subscriber with specific information relating to the amount of savings credited to his individual account, the notification required by this subdivision may be provided in the form of a table or formula mailed to the subscribers. However, a table or formula may not be used in lieu of the specific notification required by this subdivision unless such table or formula has been approved by the Commissioner. Generally, a table or formula will be approved if it enables the subscriber to simply and readily ascertain the amount of savings credited to his individual account for the taxable year, the date on which such amount was credited, and the date on which his right to such amount first would have become fixed if he had terminated his contract at the close of the company's taxable year. A reciprocal underwriter or interinsurer which desires to use such a table or formula should direct a written request for approval of such table or formula to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. Such request must set forth a copy of the table or formula proposed to be used, together with sufficient information to permit the Commissioner to determine the basis upon which such table or formula was prepared and the manner in which the subscribers will use such table or formula in determining the amounts credited to their individual accounts. Once a table or formula has been approved, the use of such table or formula with respect to savings credited for subsequent taxable years will not require further approval unless the basis upon which such table or formula was prepared, or the manner in which such table or formula is to be applied, is substantially changed. The table or formula method of notification may be used with respect to all or less than all of the company's subscribers. For example, the company might provide the notification required by this subdivision to one class of subscribers in the form of a table or formula mailed to the individual subscribers, while providing another class of subscribers with specific statements of the amounts credited to their individual accounts. The notification required by this subdivision must be mailed before the 16th day of the third month following the close of the reciprocal's taxable year for which the account was credited. Where for any taxable year a reciprocal underwriter or interinsurer claims a deduction under section 823(b) and this subparagraph and fails to give notice as required by this subdivision, such deduction shall not be allowed unless the reciprocal establishes to the satisfaction of the district director that the failure to mail such notice within the prescribed period was due to reasonable cause.

(d) *Special deduction for small company having gross amount of less than $1,100,000*—(1) *In general.* In the case of a taxpayer subject to the tax imposed by section 821(a), section 823(c) provides that if the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is less than $1,100,000, then, subject to the limitation provided in section 823(c)(2) and subparagraph (2) of this paragraph, there shall be allowed an additional deduction for purposes of determining statutory underwriting income or loss under section 823(a) for the taxable year. The amount of the additional deduction is $6,000; except that if the gross amount received for the taxable year exceeds $500,000, the additional deduction is limited to an amount equal to 1 percent of the amount by which $1,100,000 exceeds such gross amount.

(2) *Limitation.* The amount of the deduction provided by section 823(c)(1) may not exceed the statutory underwriting income for the taxable year, computed without regard to the deduction allowed under section 823(c)(1) and subparagraph (1) of this paragraph, and the deduction allowed under section 824(a) (relating to deduction for protection against losses).

(3) *Example.* The application of section 823(c) and this paragraph may be illustrated by the following example:

to the tax imposed by section 821(a), has the following items for the taxable year 1963:

Gross amount for purposes of section 823(c)(1)	$800,000
Gross investment income (including capital gains)	150,000
Capital gains	100,000
Gross income under section 832	900,000
Deductions under section 822(c)	22,000
Deductions under section 832 (as modified by section 823(b)(2))	746,000

Under the provisions of section 823(c), M's special small company deduction for the taxable year 1963 would be $3,000, computed as follows:

(1) Gross amount for purposes of section 823(c)(1)	$800,000

(2) Amount by which $1,100,000 exceeds item (1) ($1,100,000 minus $800,000)	300,000
(3) 1 percent of item (2) (not to exceed $6,000)	3,000
(4) Gross income under section 832, reduced by gross investment income ($900,000 minus $150,000)	750,000
(5) Deductions under section 832 (as modified by section 823(b)), reduced by deductions under section 822(c) ($746,000 minus $22,000)	724,000
(6) Limitation on deduction under section 823(c)(1) (excess, if any, of item (4) over item (5))	26,000
(7) Deduction under section 823(c)(1) (item (3) or item (6), whichever is the lesser)	3,000

[T.D. 6681, 28 FR 11116, Oct. 17, 1963]

§ 1.823–7 Subscribers of reciprocal underwriters and interinsurers.

A subscriber or policyholder of a reciprocal underwriter or interinsurer entitled to the deduction allowed by section 823(b)(2) and paragraph (c)(2) of § 1.823–6 shall treat amounts representing savings credit to his individual account for the taxable year as a dividend paid or declared for purposes of computing his taxable income. If a reciprocal credits savings to subscriber accounts after the close of its taxable year, but before the 16th day of the third month following the close of the taxable year, and the reciprocal takes such credits into account as if they had been made on the last day of its taxable year, the subscribers of such reciprocal must take such savings into account as if they had in fact been credited on the last day of the company's taxable year. The subscriber shall take savings credited to his account into account without regard to whether the amounts credited are actually distributed to him in cash. To the extent the insurance premium constituted a deductible expense when paid or accrued, the subscriber's taxable income for the taxable year will be increased and any loss for the taxable year will be decreased, by the amount credited to his account. Amounts credited to a subscriber's account which are taken into income by him and which subsequently are used to absorb losses of the reciprocal shall be treated by the subscriber as an additional insurance expense for the taxable year in which the amounts are absorbed. Such amounts may be deducted in computing taxable income to the extent insurance constitutes an otherwise properly deductible expense for such taxable year.

[T.D. 6681, 28 FR 11118, Oct. 17, 1963]

§ 1.823–8 Special transitional underwriting loss; cross reference.

With respect to taxable years beginning after December 31, 1962, and before January 1, 1968, section 821(f) provides, for any company subject to the tax imposed by section 821(a), a special reduction in the statutory underwriting income if such company was subject to tax under section 821 for the five taxable years immediately preceding January 1, 1962, and incurred an underwriting loss in each of such five taxable years. For rules relating to the determination of the amount of such reduction, see section 821(f) and § 1.821–5.

[T.D. 6681, 28 FR 11118, Oct. 17, 1963]

§ 1.825–1 Unused loss deduction; in general.

(a) *Amount of deduction.* Section 825(a) provides that the unused loss deduction of a mutual insurance company subject to the tax imposed by section 821(a) shall be an amount equal to the sum of the unused loss carryovers and carrybacks to the taxable year. The amount so determined is used in the computation of mutual insurance company taxable income for the taxable year. See section 821(b) and § 1.821–4.

(b) *Unused loss defined.* Section 825(b) defines the term ''unused loss'' as the amount (if any) by which:

(1) The sum of the statutory underwriting loss (as defined in section 823(a)(2)) and the investment loss (as defined in section 822(a)(2)) exceeds

(2) The sum of:

(i) The taxable investment income (as defined in section 822(a)(1)),

(ii) The statutory underwriting income (as defined in section 823(a)(1)), and

(iii) The amounts required to be subtracted from the protection against loss account under section 824(d).

(c) *Steps in computation of unused loss deduction.* The three steps to be taken in the ascertainment of the unused loss deduction for any taxable year are as follows:

(1) Compute the unused loss for any preceding or succeeding taxable year from which an unused loss may be carried over or carried back to the taxable year.

(2) Compute the unused loss carryovers to the taxable year from such preceding taxable years and the unused loss carrybacks to the taxable year from such succeeding taxable years.

(3) Add such unused loss carryovers and carrybacks in order to determine the unused loss deduction for the taxable year.

(d) *Statement with tax return.* Every mutual insurance company taxable under section 821(a) claiming an unused loss deduction for any taxable year shall file with its return for such year a concise statement setting forth the amount of the unused loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the unused loss deduction.

(e) *Ascertainment of deduction dependent upon unused loss carryback.* If a mutual insurance company taxable under section 821(a) is entitled in computing its unused loss deduction to a carryback which it is not able to ascertain at the time its return is due, it shall compute the unused loss deduction on its return without regard to such unused loss carryback. When the company ascertains the unused loss carryback, it may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the unused loss deduction for the taxable year with the inclusion of such carryback; or it may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(f) *Law applicable to computations.* The following rules shall apply to taxable years for which the taxpayer is subject to the tax imposed by section 821(a):

(1) In determining the amount of any unused loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The unused loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the unused loss deduction.

(3) The amount of the unused loss deduction which shall be allowed for any taxable year shall be determined under the law applicable for that year.

[T.D. 6681, 28 FR 11122, Oct. 17, 1963]

§ 1.825–2 Unused loss carryovers and carrybacks.

(a) *Years to which loss may be carried*—(1) *In general.* In order to determine its unused loss deduction for any taxable year, a mutual insurance company taxable under section 821(a) must first determine the part of any unused losses for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. An unused loss is to be an unused loss carryback to each of the 3 taxable years preceding the loss year, and an unused loss carryover to each of the 5 taxable years following the loss year, subject to the limitations provided in section 825(g) and subparagraph (2) of this paragraph.

(2) *Limitations.* An unused loss may not be carried:

(i) To or from any taxable year beginning before January 1, 1963,

(ii) To or from any taxable year for which the taxpayer is not subject to the tax imposed by section 821(a), nor

(iii) To any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the taxpayer was not subject to the tax imposed by section 821(a).

(3) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 825 the first, second, etc., preceding or succeeding taxable year.

(b) *Loss year defined.* The term ''loss year'' as used in this section means any taxable year for which a company subject to the tax imposed by section 821(a) has an unused loss in excess of zero.

(c) *Amount of carrybacks and carryovers.* Section 825(e) provides that in the case of a loss year for a company taxable under section 821(a), the entire amount of the unused loss shall be carried to the earliest taxable year to which such loss may be carried under section 825(d) (subject to the limitations of section 825(g)). The amount of the unused loss carried to each of the other taxable years to which such loss may be carried under section 825(d) following such earliest taxable year shall be the excess (if any) of such loss over the sum of the offsets for each taxable year preceding the taxable year to which the unused loss is carried.

(d) *Offset defined*—(1) *In general.* Section 825(f) defines the term ''offset'' and provides that the taxable year to which an unused loss is carried shall be referred to as the ''offset year''. The definition of the term offset in the case of an unused loss carryback to an offset year, differs from the definition of such term in the case of an unused loss carryover to an offset year.

(2) *Offset in case of carryback.* In the case of an unused loss carryback from the loss year to the offset year, the offset is the mutual insurance company taxable income for the offset year, computed without regard to any unused loss carryback from the loss year or any taxable year thereafter.

(3) *Offset in case of carryover.* In the case of an unused loss carryover from the loss year to the offset year, the offset is equal to the sum of:

(i) The amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) (relating to amounts equal to the unused loss carryovers to the offset year), plus

(ii) The mutual insurance company taxable income for the taxable year, computed without regard to any unused loss carryback or carryover from the loss year or any taxable year thereafter.

[T.D. 6681, 28 FR 11123, Oct. 17, 1963]

§ 1.825–3 Examples.

The application of section 825 may be illustrated by the following examples:

Example 1. For the taxable year 1967, F, a mutual insurance company subject to the tax imposed by section 821(a), has the following items:

Taxable investment income	1
Underwriting loss	59
Addition to protection against loss account	8
Statutory underwriting loss	67

The subtractions from the protection against loss account are as follows:

Amount subtracted from amounts in account with respect to taxable years 1963 through 1966	18
Amount subtracted from amounts in account with respect to taxable year 1967	8
Total subtractions from protection against loss account under section 824(d)	26

The application of section 825 in this case may be illustrated by the facts and results shown in the following table and explained below:

TAXABLE YEAR

	1963	1964	1965	1966	1967	1968
Protection against loss account:						
Addition to account during taxable year	6	2	3	7	8	7
Subtraction from account during taxable year	0	0	0	0	8	7
Protection against loss account (at end of year)	6	2	3	7	0	0
Protection against loss account (at end of taxable year 1968)	0	0	0	0	0	0
Unused loss	0	0	0	0	40	0
Unused loss carryback	0	40	35	25	0	0
Unused loss carryover	0	0	0	0	0	18
Unused loss deduction	0	40	35	25	0	18
Mutual insurance company taxable income (computed without regard to unused loss)	13	5	10	7	0	2
Mutual insurance company taxable income (computed with regard to unused loss)	13	0	0	0	0	0
Offset for year	0	5	10	7	0	9
Offset total	0	5	15	22	22	31

1967: Under the provisions of section 825(b), F's unused loss for 1967 is 40, the amount by which the sum of the statutory underwriting loss and the investment loss, 67 (67 plus 0), exceeds the sum of the taxable investment income, the statutory underwriting income, and the amounts required to be subtracted from the protection against loss account under section 824(d) for the taxable year, 27 (the sum of 1, 0, and 26, respectively).

1967 carryback to 1964: Under the provisions of section 825(e), the entire unused loss for 1967 of 40 is carried back to 1964, the earliest year to which the loss may be carried under section 825(d). Since there are no other amounts carried to 1964, the unused loss deduction for 1964 is 40. Thus, after taking the unused loss deduction into account, the mutual insurance company taxable income for 1964 is zero, and the offset for 1964 is 5 (the mutual insurance company taxable income for 1964 determined without regard to the unused loss carryback from 1967 or any year thereafter).

1967 carryback to 1965: The portion of the unused loss for 1967 which is carried back to 1965 is 35 (40 minus 5, the offset for 1964). After taking the unused loss deduction into account, the mutual insurance company taxable income for 1965 is zero. The offset for 1965 is 10, the mutual insurance company taxable income for 1965 determined without regard to any unused loss carryback from 1967 or any year thereafter.

1967 carryback to 1966: The portion of the unused loss for 1967 which is carried back to 1966 is 25. This amount is the excess of the unused loss for 1967 of 40 over the sum of the offset for 1964 (5) and the offset for 1965 (10). As a result of the unused loss deduction the mutual insurance company taxable income for 1966 is reduced to zero. The offset for 1966 is 7.

1967 carryover to 1968: Under the provisions of section 825(d), the portion of the unused loss for 1967 which is carried forward to 1968 is 18 (40 minus the sum of 5, 10, and 7, the offsets for 1964, 1965, and 1966, respectively). Under section 825(f)(2), this amount is first applied against any amounts in the protection against loss account at the end of 1968, and is then applied against the mutual insurance company taxable income for 1968 (computed without regard to any unused loss carryovers or carrybacks from 1967 or any taxable year thereafter). Thus, assuming that there are no other subtractions from its protection against loss account under section 824(d) for 1968, F's protection against loss account of 7 is reduced to zero by reason of the subtraction under section 824(d)(1)(C). The remaining portion of the unused loss for 1967 which is carried to 1968, 11 (18 minus 7, the amount of the unused loss carryover to 1968 which is subtracted from the protection against loss account under section 824(d)(1)(C)), is then applied against the mutual insurance company taxable income for 1968 computed without regard to any unused carryback or carryover from the loss year (1967) or any taxable year thereafter. After the application of the unused loss deduction for 1968, the mutual insurance company taxable income for 1968 is zero. The offset for 1968 is 9, the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for 1968 (7), plus the mutual insurance company taxable income for 1968, determined without regard to any unused loss carryover or carryback from 1967 or any year thereafter (2). The remaining 9 of the unused loss for 1967 (40 minus the sum of 5, 10, 7, and 9, the offsets for 1964, 1965, 1966, and 1968, respectively), is carried forward to 1969, and to the extent not used in that year or any year thereafter, may be carried forward to 1970, 1971, and 1972, in that order.

Example 2. If in example 1 F had an unused loss in 1966 of 22, then, with respect to F's 1967 unused loss of 40, the offset for 1964 would be zero; the offset for 1965 would be 6—the 1965 mutual insurance company taxable income of 10 less an unused loss carryback of 4 from 1966 (the 1966 unused loss of 22 minus the 1963 offset of 13 and the 1964 offset of 5); the offset for the loss year 1966 would be zero, and 34 (the 1967 unused loss of 40 minus the offset for 1965 of 6) would remain as an unused loss carryover to 1968, 1969, 1970, 1971, 1972, in that order. Thus, the unused loss carrybacks or carryovers to an offset year are applied against the mutual insurance company taxable income for such year in the order in which the losses occurred, with the earliest loss being offset first.

Example 3. For the taxable year 1963, M, a mutual insurance company subject to tax imposed by section 821(a), has an unused loss (as defined in section 825(b)) of $65,000. Under section 825(g), the loss may not be carried back to any taxable year beginning before 1963. However, the loss may be carried forward to each of the 5 taxable years following 1963 provided that for each of such succeeding taxable years M is subject to the tax imposed by section 821(a).

Example 4. Assume the facts are the same as in example 3, except that for the taxable year 1964, the gross amount received by M from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) exceeds $150,000 but does not exceed $500,000. If M does not make the election under section 821(d) (relating to election to be taxed under section 821(a)) for 1964, M's 1963 unused loss of $65,000 will not be allowed as an unused loss carryover or carryback since, by reason of section 825(g)(3), the unused loss may not be carried to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a), and by reason of section 825(g)(1), the unused loss may not be carried to any taxable year beginning before 1963.

[T.D. 6681, 28 FR 11123, Oct. 17, 1963]

§ 1.826–1 Election by reciprocal underwriters and interinsurers.

(a) *In general.* Except as otherwise provided in section 826(c), any mutual insurance company which is an interinsurer or reciprocal underwriter taxable under section 821(a) may elect under section 826(a) to limit its deductions for amounts paid or incurred to its attorney-in-fact to the deductions of its attorney-in-fact which are allocable to income received by the attorney-in-fact from the reciprocal during the taxable year. See § 1.826–4 for rules relating to allocation of expenses. In no case may such an election increase the amount deductible by the reciprocal for amounts paid or due its attorney-in-fact for the taxable year. The election allowed by section 826(a) and this section in effect increases the income of the reciprocal by the net income of the attorney-in-fact attributable to its business with the reciprocal. A reciprocal making the election is allowed a credit for the amount of tax paid by the attorney-in-fact for the taxable year which is attributable to income received by the attorney-in-fact from the reciprocal. See section 826(e) and § 1.826–5.

(b) *Companies eligible to elect under section 826(a).* Any mutual insurance company which is a reciprocal underwriter or interinsurer subject to the tax imposed by section 821(a) may elect (in the manner prescribed by paragraph (c) of this section) to be subject to the limitation provided by section 826(b) and paragraph (a) of this section provided the attorney-in-fact of the electing reciprocal:

(1) Is subject to the taxes imposed by section 11 (b) and (c) and the regulations thereunder;

(2) Consents (in the manner provided by paragraph (a) of § 1.826–3) to provide the information required under paragraph (b) of § 1.826–3 during the period in which the election made under section 826(a) and this section is in effect;

(3) Reports the income received from the reciprocal and the deductions allocable thereto under the same method of accounting used by the reciprocal in reporting its deductions for amounts paid or due its attorney-in-fact; and

(4) Files its income tax return on a calendar year basis.

(c) *Manner of making election.* The election provided by section 826(a) and this section shall be made in a statement attached to the taxpayer's income tax return for the first taxable year for which such election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or its duly authorized representative), and shall be filed not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the first taxable year for which such election is to apply. For information required of an electing reciprocal, see paragraph (e) of this section.

(d) *Scope of election.* The election allowed by section 826(a) is binding for the taxable year for which made and all succeeding taxable years unless the Commissioner consents to a revocation of such election. Whether revocation will be permitted will depend upon the facts and circumstances of each particular case.

(e) *Information required of an electing company.* Every reciprocal underwriter or interinsurer making the election provided by section 826(a) and this section shall, in the manner provided by paragraph (f) of this section, furnish the following information for each taxable year during which such election is in effect:

(1) The name and address of the attorney-in-fact with respect to which the election allowed by section 826(a) and this section is in effect; the district in which such attorney-in-fact filed its return for the taxable year; and a copy of the consent required by section 826 and § 1.826–3 and the date and district in which such consent was filed;

(2) The deductible amount paid or due to such attorney-in-fact from the reciprocal computed without regard to the limitation provided by section 826(b);

(3) The total amount claimed as a deduction by the reciprocal for amounts paid to its attorney-in-fact after giving effect to the limitation provided by section 826(b);

(4) The amount of the increase (if any) in underwriting gain (as defined in section 824(a)) attributable to the election allowed by section 826(a);

(5) The amount of the increase (if any) in the deduction allowed by section 824(a) (relating to deduction to provide protection against losses) attributable to the election allowed by section 826(a);

(6) The amount of any increase or decrease in the statutory underwriting income or loss for the taxable year (as computed under section 823) attributable to the election allowed by section 826(a);

(7) The amount of any increase or decrease in the mutual insurance company taxable income or unused loss for the taxable year attributable to the election allowed by section 826(a);

(8) The amount of the increase (if any) in the tax liability of the reciprocal for the taxable year attributable to the election allowed by section 826(a) before taking into account the credit provided by section 826(e);

(9) The amount of tax attributable to income received by the attorney-in-fact from the reciprocal during the taxable year (as determined under §1.826–5) claimed (under section 826(e) and paragraph (a) of this section) by the reciprocal as a credit for the taxable year; and

(10) The information which the attorney-in-fact is required to submit to the reciprocal under paragraphs (b) and (c) of §1.826–3.

(f) *Manner in which information is to be provided.* The information required by paragraph (e) of this section shall be set forth in a statement attached to the taxpayer's income tax return for each taxable year for which such information is required. Such statement shall include the name and address of the taxpayer; and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year with respect to which such information is being provided.

[T.D. 6681, 28 FR 11124, Oct. 17, 1963]

§ 1.826–2 Special rules applicable to electing reciprocals.

(a) *Protection against loss account.* Section 826(d) provides that for purposes of determining the amount to be subtracted from the protection against loss account under section 824(d)(1)(D) and the regulations thereunder (relating to amounts added to the account for the fifth preceding taxable year) for any taxable year, any amount which was added to such account by reason of the election under section 826(a) and paragraph (a) of §1.826–1 shall be treated as having been added by reason of section 824(a)(1)(A) and the regulations thereunder (relating to amounts equal to 1 percent of losses incurred during the taxable year). Thus, no amount added to the protection against loss account by reason of an election made under section 826(a) may remain in such account beyond the end of the fifth taxable year following the taxable year with respect to which such amount was added. See section 824(d)(1)(D) and paragraph (b)(3) of §1.824–1. The amount added to the protection against loss account by reason of an election under section 826(a) is that amount which is equal to 25 percent (plus, in the case of a reciprocal which qualifies as a concentrated risk company under section 824(a), so much of the concentrated wind-storm, etc., premium percentage as exceeds 40 percent) of the amount by which:

(1) The underwriting gain (as defined by section 824(a)(1)) computed after taking into account the limitation provided by section 826(b) and §1.826–1, exceeds

(2) The underwriting gain computed without regard to the limitation provided by section 826(b) and §1.826–1.

(b) *Denial of surtax exemption.* Section 826(f) provides that the tax imposed upon any increase in the mutual insurance company taxable income of a reciprocal which is attributable to the limitation provided by section 826(b) shall be computed without regard to the surtax exemption provided by section 821(a)(2) and the regulations thereunder. Thus, a company making the election provided under section 826(a) will be subject to surtax, as well as normal tax, on the increase in its mutual insurance company taxable income for the taxable year which is attributable to such election. Similarly, any amount which was added to the protection against loss account by reason of an election under section 826(a) and §1.826–1, and which is subtracted from such account in accordance with section 826(d) and paragraph (a) of this section, will be subject to surtax, as well as normal tax, to the extent such amount increases mutual insurance company taxable income in the year in which the subtraction is made. Furthermore, the company will be subject to surtax on such increases notwithstanding the fact that it may have no normal tax liability for the taxable year, because its mutual insurance company taxable income (after giving effect to the election provided by section 826(a)) does not exceed $6,000.

(c) *Adjustment for refunds.* Section 826(g) provides that if for any taxable year an attorney-in-fact is allowed a credit or refund for taxes paid with respect to which credit or refund to the reciprocal resulted under section 826(e), the taxes of such reciprocal for such taxable year shall be properly adjusted. The reciprocal shall make the adjustment required by section 826(g) by increasing its income tax liability for its taxable year in which the credit or refund is allowed to the attorney-in-fact by the amount of such credit or refund which is attributable to taxes paid by the attorney-in-fact on income received from the reciprocal, as determined under §1.826–6, but only to the extent that the payment of such amount by the attorney-in-fact resulted in a credit or refund to the reciprocal. However, if the refund or credit to the attorney-in-fact is the result of an error in determining its items of income or deduction for the taxable year with respect to which the refund or credit is allowed, and such error affects the amount of deductions allocable to its reciprocal for such taxable year, then, if the reciprocal's period for filing an amended return has not otherwise expired, the preceding sentence shall not apply and the reciprocal shall make the adjustment required by section 826(g) by filing an amended return for such taxable year and all subsequent taxable years for which an adjustment is required. The reciprocal's amended return or returns shall give effect to the change in the deductions of the attorney-in-fact allocable to income received from the reciprocal and the tax paid by the attorney-in-fact attributable to such income. The amount of any adjustment required by section 826(g) and this section and the computation thereof shall be set forth in a statement attached to and filed with the taxpayer's income tax return for the taxable year for which the adjustment is made. Such statement shall include the name and address of the taxpayer, and a copy of the notification received by the attorney-in-fact indicating that it has been allowed the credit or refund requiring adjustment of the reciprocal's taxes.

[T.D. 6681, 28 FR 11125, Oct. 17, 1963, as amended by T.D. 7100, 36 FR 5334, Mar. 20, 1971]

§ 1.826–3 Attorney-in-fact of electing reciprocals.

(a) *Manner of making consent.* Section 826(c)(2) provides that a reciprocal may not elect to be subject to the limitation provided by section 826(b) unless its attorney-in-fact consents to make certain information available. See paragraph (b) of this section. The attorney-in-fact of a reciprocal making the election provided by section 826(a) shall signify the consent required by section 826(c) in a statement attached to its income tax return for the first taxable year for which the reciprocal's election is to apply. Such statement shall include the name and address of the consenting taxpayer; the name and address of the reciprocal with respect to which such consent is to apply; shall be signed by the taxpayer (or its duly authorized representative); and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the first taxable year for which such consent is to apply. In addition, such statement shall specify that the taxpayer is subject to the taxes imposed by section 11 (b) and (c); the method of accounting used in reporting income received from its reciprocal and the deductions allocable thereto; and that its return is filed on the calendar year basis. Consent, once given, shall be irrevocable for the period during which the election provided for the reciprocal by section 826(a) is in effect. See paragraph (e) of §1.826–1.

(b) *Information required of consenting attorney-in-fact.* Every attorney-in-fact making the consent provided by section 826(c)(2) and paragraph (a) of this section shall, in the manner prescribed by paragraph (c) of this section, furnish the following information for each taxable year during which the consent provided by section 826(c)(2) and paragraph (a) of this section is in effect:

(1) The name and address of the reciprocal with respect to which the consent required by section 826(c)(2) and paragraph (a) of this section is to apply;

(2) Gross income in total and by sources, adjusted for returns and allowances;

(3) Deductions (itemized to the same extent as on taxpayer's income tax return and accompanying schedules) allocable to each source of gross income and in total (see § 1.826–4);

(4) Method of allocation used in subparagraph (3) of this paragraph;

(5) Taxable income (if any) in total and by sources, as in subparagraph (2) of this paragraph (income by sources from subparagraph (2) of this paragraph minus expenses allocable thereto under subparagraph (3) of this paragraph);

(6) Total income tax liability (if any) for the taxable year;

(7) Taxes paid attributable (under § 1.826–5) to income earned by the taxpayer in dealing with the reciprocal;

(8) Such other information as may be required by the district director.

(c) *Manner in which information is to be provided.* (1) The information required by paragraph (b) of this section shall be set forth in a statement attached to the taxpayer's income tax return for each taxable year for which the consent provided by section 826(c)(2) and paragraph (a) of this section is in effect. Such statement shall include the name and address of the taxpayer, and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for each taxable year for which such information is required.

(2) A copy of the statement containing the information required by paragraph (b) of this section shall be submitted to the board of advisors (or other comparable body) of the reciprocal on whose behalf the consent provided under section 826(c)(2) is given. The copy shall be executed in the same manner as the original and shall be delivered to such board not later than 10 days before the last date prescribed by law (including extensions thereof) for filing the reciprocal's income tax return for the taxable year for which the information is required unless the attorney-in-fact establishes to the satisfaction of the district director that the failure to furnish such copy or the failure to furnish such copy within the prescribed 10 day period was due to circumstances beyond its control. In addition, there shall be attached to and made a part of such copy, a copy of the income tax return of the attorney-in-fact (including accompanying schedules) for each taxable year for which such statement is required.

[T.D. 6681, 28 FR 11125, Oct. 17, 1963]

§ 1.826–4 Allocation of expenses.

An attorney-in-fact allocating expenses as required by section 826(b) and paragraph (b) of § 1.826–3 shall allocate each expense itemized in its income tax return (and accompanying schedules) for the taxable year to each source of gross income (as set forth pursuant to paragraph (b)(2) of § 1.826–3). However, no portion of the net operating loss deduction allowed by section 172 shall be allocated to income received or due from the reciprocal, and no expenses, other than those directly related thereto, shall be allocated to capital gains. Where the method of allocation used by the taxpayer does not reasonably reflect the expenses of the taxpayer allocable to income received or due from the reciprocal, the district director may require the taxpayer to use such other method of allocation as is reasonable under the circumstances.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§ 1.826–5 Attribution of tax.

(a) *In general.* Section 826(e) provides that a reciprocal making the election allowed by section 826(a) shall be credited with so much of the tax paid by the attorney-in-fact as is attributable to the income received by the attorney-in-fact from the reciprocal in such taxable year.

(b) *Computation.* For purposes of section 826(e) and paragraph (a) of this section, the amount of tax attributable to income received by the attorney-in-fact from the reciprocal in the taxable year shall be computed in the following manner:

(1) First, compute the taxable income (if any) from each source of gross income set forth in paragraph (b)(2) of § 1.826–3 by deducting from each such amount the expenses allocable thereto under § 1.826–4;

(2) Second, compute the normal tax on each amount of taxable income computed in subparagraph (1) of this paragraph at the rate provided by section 11(b) of the Code;

(3) Third, deduct from each amount determined in subparagraph (1) of this paragraph an amount which bears the same proportion to the surtax exemption provided by section 11(c) of the Code as each amount computed under subparagraph (1) of this paragraph bears to the total of the amounts computed under subparagraph (1) of this paragraph;

(4) Fourth, compute the surtax on each remainder computed in subparagraph (3) of this paragraph at the rate provided by section 11(c) of the Code;

(5) Fifth, add the normal tax computed under subparagraph (2) of this paragraph to the surtax computed under subparagraph (4) of this paragraph for each amount computed under subparagraph (1) of this paragraph;

(6) Sixth, deduct from each amount of tax computed under subparagraph (5) of this paragraph any tax credits (other than those arising from payments made with respect to the tax liability for the taxable year or other taxable years) allocable (in the same manner as provided for expenses under § 1.826–4) to such amount;

(7) Seventh, compute that amount which bears the same proportion to the tax actually paid with respect to the taxable year as each individual amount computed under subparagraph (6) of this paragraph bears to the total of the amounts computed under subparagraph (6) of this paragraph. The amount so determined with respect to each amount computed under subparagraph (6) of this paragraph is the tax paid which is attributable to the amount computed under subparagraph (1) of this paragraph.

To the extent the amounts determined under subparagraph (1) of this paragraph are attributable to amounts received from the reciprocal for the taxable year, the tax attributable to such amounts (as determined under subparagraph (7) of this paragraph) shall be the amount of tax attributable to income received by the attorney-in-fact from the reciprocal during the taxable year.

(c) *Taxes of attorney-in-fact unaffected.* Nothing in section 826 or the regulations thereunder shall increase or decrease the taxes imposed on the income of the attorney-in-fact.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§ 1.826–6 Credit or refund.

(a) *Notification required.* In any case where a taxpayer applies for a credit or refund of taxes paid by it in respect of a taxable year for which the taxpayer was the consenting attorney-in-fact of a reciprocal making the election provided by section 826(a), such taxpayer shall give notice to its reciprocal for such taxable year, first, upon applying for the credit or refund; and again, within 10 days from the date on which a final determination is made that such credit or refund has been allowed or denied.

(b) *Notice form.* The notices required by this section shall include the name and address of the taxpayer and shall be signed by the taxpayer or its duly authorized representative. In addition, there shall be attached to and made a part of each first notice a concise statement of the claim upon which the application for refund or credit is based; and there shall be attached to and made a part of each second notice:

(1) A copy of the notification (if any) received by the taxpayer indicating that the credit or refund has been allowed; and

(2) A statement setting forth the amount of such credit or refund attributable to taxes paid by the taxpayer on income received from the reciprocal, and the computation by which such amount was determined.

(c) *Manner of apportioning refund or credit.* The taxpayer shall determine the amount of the refund or credit attributable to taxes paid on income received from its reciprocal by reallocating its income and expense items for the taxable year, with respect to which the refund or credit is allowed, in the manner provided by §§ 1.826–3 and 1.826–4 so as to reflect the adjustments (if any) in such items which resulted in the credit or refund of tax for the taxable year. The taxpayer shall then recompute the tax attributable to income received from its reciprocal for such taxable year in the manner provided by § 1.826–5. The district director may require such additional information as may be necessary in the circumstances to verify the computations required by this paragraph.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§ 1.826–7 Examples.

The application of section 826 may be illustrated by the following examples:

Example 1. For the taxable year 1963, R, a reciprocal underwriter subject to the taxes imposed by section 821(a), has the following items (determined before applying any election under section 826):

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	$100	
All other deductions	500	
Total deductions under sec. 832	600	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		4
Underwriting gain		0
Mutual insurance company taxable income		0
Unused loss		22
Credit or refund for taxes paid		0

Assume that the deductions of attorney-in-fact A allocable to the income received by A from R are 60 and the tax paid by A allocable to the income received from R is 16. If R elects to be subject to the limitation provided in section 826(b), the results for 1963 would be as follows:

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	$60	
All other deductions	500	
Total deduction under sec. 832	560	
Deductions under sec. 822(c)		40
Incurred losses		400
Underwriting gain		8
Protection against loss deduction		6
Mutual insurance company taxable income		12
Unused loss		0
Credit or refund for taxes paid		16

Under the provisions of section 826(b), R's deduction for amounts paid or incurred to the attorney-in-fact in the taxable year 1963 would be limited to the deductions of A allocable to the income received by A from R. Thus, R's deductions under section 832 (as modified by section 823(b)) for 1963 would be 60 (the deductions of A which are allocable to the income received by A from R). As a result of making the election under section 826(a) for the taxable year 1963, R's underwriting gain would be 8, and its statutory underwriting income would be 2 (the underwriting gain of 8 minus the protection against loss deduction of 6—of which 4 represents the amount determined under section 824(a)(1)(A)—and 2 represents the amount determined under section 824(a)(1)(B)—or 8 minus 6). R's mutual insurance company taxable income for 1963 would be 12, consisting of taxable investment income of 10 (gross investment income minus deductions under section 822(c), or 50 minus 40) plus statutory underwriting income of 2. Since all of R's mutual insurance company taxable income of 12 is attributable to the limitation under section 826(b), the entire amount is subject to the surtax under section 821(a)(2) without regard to the $25,000 surtax exemption. The credit of 16, representing that part of the tax paid by A which is allocable to the income received by A from R, may be applied by R against its taxes with respect to its mutual insurance company taxable income of 12 for 1963, and R would be entitled to a refund of any excess of the amount of such credit over its tax liability for 1963.

Under the provisions of section 826(d), no portion of the amount added to the protection against loss account in 1963 by reason of the election under section 826(a), 2 (25 percent of the amount by which the consolidated underwriting gain exceeds 25 percent of the underwriting gain determined without regard to the election under section 826(a), or the amount by which 25 percent of 8 exceeds 25 percent of 0), may remain in such account beyond the taxable year 1968.

Example 2. For the taxable year 1963, F is a corporate attorney-in-fact subject to the taxes imposed by section 11(b) and (c) of the Code. F files its return on the calendar year basis and reports income received from its reciprocal and the deductions allocable thereto under the same method of accounting used by its reciprocal in reporting its deductions for amounts paid to R. F properly consents to provide the information required by paragraph (b) of § 1.826–3. In addition to its attorney-in-fact business, F owns real estate for investment purposes, and operates a real estate management service. For the taxable year 1963, F has gross income from these various sources as follows:

Attorney-in-fact fees	$85,000
Real estate management fees	18,000

Rental income 25,000

F allocates its expenses for the taxable year on the basis of their direct relation to each source of income. During 1963, F acquired property for use in its attorney-in-fact operations which entitled F to an investment credit of $800 under section 38. For 1963, F determines that the tax paid by it which is attributable to its reciprocal is $21,863, computed as follows:

	Attorney-in-fact fees	Real estate management	Rental income	Total
Gross income	$85,000	$18,000	$25,000	$128,000
Allocable expenses	25,000	3,000	35,000	63,000
Taxable income (loss)	60,000	15,000	(10,000)	65,000
Normal tax (30 percent)	18,000	4,500	0	19,500
Surtax exemption ..	20,000	5,000	0	25,000
Income subject to surtax	40,000	10,000	0	40,000
Surtax (22 percent) ..	8,800	2,200	0	8,800
Total tax	26,800	6,700	0	28,300
Investment credit	800	0	0	800
1963 tax liability	26,000	6,700	0	27,500
1963 tax paid	....	....	....	27,500
Allocation of tax paid ..	21,863	5,637	0	27,500

Under paragraph (b)(1) of §1.826–5, F computes its taxable income from its attorney-in-fact fees to be $60,000 ($85,000 minus $25,000), and its taxable income from its real estate management to be $15,000 ($18,000 minus $3,000). Since F's rental operations resulted in a $10,000 loss for the taxable year ($25,000 minus $35,000), F's taxable income from its rental operations is zero. Using the 30 percent rate provided by section 11(b), F computes its normal tax to be $18,000 on its attorney-in-fact fees and $4,500 on its real estate management operations. F's normal tax on total income is $19,500. The $3,000 difference between the normal tax on F's total income and the normal taxes on F's profitable operations results from the loss on F's rental operations. Under paragraph (b)(3) of §1.826–5, F allocates its surtax exemption as follows: $20,000 $60,000/$75,000×$25,000) to its attorney-in-fact fees; and $5,000 $15,000/$75,000×$25,000) to its real estate management operations. F computes its surtax on its profitable operations at the 22 percent rate provided by section 11(c) as follows: $8,800 (22 percent of $40,000) on attorney-in-fact fees; and $2,200 (22 percent of $10,000) on real estate management income. F adds its normal tax and surtax on its profitable operations and determines its total tax to be $26,800 on its attorney-in-fact operations; $6,700 on its real estate management operations; and $28,300 on its total income. F must allocate its investment credit on the same basis as it used to allocate its expenses. Thus, F's entire investment credit must be allocated to its attorney-in-fact operations. Accordingly, F's 1963 tax liability is $26,000 on its attorney-in-fact fees; $6,700 on its real estate management operations; $0 on its rental operations; and $27,500 on its total income. Under paragraph (b)(7) of §1.826–5, F allocates $21,863 ($26,000/$32,700×$27,500) of its 1963 tax paid to its attorney-in-fact fees; and $5,637 ($6,700/$32,700×$27,500) of its 1963 tax paid to its real estate management business. F's reciprocal will be allowed a credit or refund of $21,863 for taxes paid by F which are attributable to F's income received from its reciprocal.

Example 3. Assume the same facts as in example 2, and assume further that in 1966 F sustains a net operating loss on its overall operations of $5,000. In carrying the loss back to 1963 as a net operating loss deduction under section 172, F must allocate the deduction under the same method it used in allocating its 1963 deductions. Thus, if the loss was entirely attributable to F's rental operations for the taxable year 1966, F would reduce its taxable income attributable to those operations by the entire amount of the loss and would recompute the tax attributable to those operations under paragraph (b) of §1.826–5. As recomputed in the table below, F's 1963 tax liability from attorney-in-fact fees would be $19,800 and F's total tax liability would be $24,900.

	Attorney-in-fact fees	Real estate management	Rental income	Total
Gross income	$85,000	$18,000	$25,000	$128,000
Allocable expenses	25,000	3,000	35,000	63,000
Net operating loss deduction	0	0	5,000	5,000
Taxable income (loss)	60,000	15,000	(15,000)	60,000
Normal tax (30 percent)	18,000	4,500	0	18,000
Surtax exemption ..	20,000	5,000	0	25,000
Income subject to surtax	40,000	10,000	0	35,000
Surtax (22 percent) ..	8,800	2,200	0	7,700
Total tax	26,800	6,700	0	25,700
Investment credit	800	0	0	800
1963 tax liability	26,000	6,700	0	24,900

	Attorney-in-fact fees	Real estate management	Rental income	Total
1963 tax paid	....	....	....	24,900
Allocation of tax paid ..	19,800	5,100	0	24,900

As a result of its 1966 net operating loss, F would be entitled to a refund of $2,600 (1963 taxes paid of $27,500 minus recomputed 1963 taxes of $24,900). Under paragraph (a) of §1.826–6, F would be required to notify its reciprocal of its claim for refund and of the amount of the refund or credit attributable to taxes paid on income received from the reciprocal. Since the 1963 tax paid by F attributable to its reciprocal (as recomputed) is less than the amount claimed in 1963 by F's reciprocal as a credit, F's reciprocal would be required, under section 826(g), to add the difference—$2,063 ($21,863 minus $19,800), to its tax liability for 1966. Thus, F's reciprocal would first compute its tax liability for 1966 without regard to section 826(g) and then would increase such liability by $2,063.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

OTHER INSURANCE COMPANIES

§ 1.831–1 Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies.

(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire insurance companies exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which, except for such deduction of underwriting costs as may be provided, is refundable upon cancellation or expiration of the policy, are subject to the tax imposed by section 831. As used in this section and §§1.832–1 and 1.832–2, the term ''insurance companies'' means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of §1.801–1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code.

(d) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11(b) and the surtax shall be computed as provided in section 11(c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

§ 1.831–2 Taxable years affected.

Section 1.831–1 is applicable only to taxable years beginning after December 31, 1953, but before January 1, 1963, and ending after August 16, 1954, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 and the regulations thereunder before amendments. Section 1.831–3 is applicable only to taxable years beginning after December 31, 1962, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 as amended. Section 1.831–4 is applicable only with respect to the companies described therein, and only with respect to taxable years beginning after December 31, 1961.

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.831–3 Tax on insurance companies (other than life or mutual), mutual marine insurance companies, mutual fire insurance companies issuing perpetual policies, and mutual fire or flood insurance companies operating on the basis of premium deposits; taxable years beginning after December 31, 1962.

(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire or flood insurance companies exclusively issuing perpetual policies or whose principal business is the issuance of policies for which the premium deposits are the same regardless of the length of the term for which the policies are written, are subject to the tax imposed by section 831 if the unabsorbed portion of such premium deposits not required for losses, expenses or reserves is returned or credited to the policyholder on cancellation or expiration of the policy. For purposes of section 831 and this section, in the case of a mutual flood insurance company, the premium deposits will be considered to be the same if the payment of a premium increases the total insurance under the policy in an amount equal to the amount of such premium and the omission of any annual premium does not result in the reduction or suspension of coverage under the policy. As used in this section and section 832 and the regulations thereunder, the term ''insurance companies'' means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of § 1.801–1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code.

(d) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11(b) and the surtax shall be computed as provided in section 11(c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.831–4 Election of multiple line companies to be taxed on total income.

(a) *In general.* Section 831(c) provides that any mutual insurance company engaged in writing marine, fire, and casualty insurance which, for any 5-year period beginning after December 31, 1941, and ending before January 1, 1962, was subject to the tax imposed by section 831 (or the tax imposed by corresponding provisions of prior law) may elect, in the manner provided by paragraph (b) of this section, to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income. A company making an election under section 831(c) and this section will be subject to the tax imposed by section 831 for taxable years beginning after December 31, 1961, rather than subject to the tax imposed by section 821.

(b) *Time and manner of making election.* The election provided by section 831(c) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year 1962. The statement shall indicate that the taxpayer has made the election provided by section 831(c) and this section; shall include the name and address of the taxpayer, and shall be signed by the taxpayer or his duly authorized representative. In addition, the statement shall list the 5 consecutive taxable years prior to 1962 for which the taxpayer was subject to tax under section 831 (or the corresponding provisions of prior law); the types of insurance written by the company; and the percentage of marine insurance to total insurance written. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for the taxable year 1962. However, if the last date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year 1962 falls before October 17, 1963, the election provided by section 831(c) and this section may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before January 16, 1964.

(c) *Scope of election.* An election made under section 831(c) and paragraph (b) of this section shall be binding for all taxable years beginning after December 31, 1961, unless consent to revoke the election is obtained from the Commissioner. However, if a taxpayer made the election provided by section 831(c) and this section for taxable years beginning prior to October 17, 1963, the taxpayer may revoke such election without obtaining consent from the Commissioner by filing, before January 16, 1964, a statement that the taxpayer desires to revoke such election. Such statement shall be signed by the taxpayer or its duly authorized representative. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(d) *Limitation on certain net operating loss carryovers and carrybacks.* In the case of a taxpayer making the election allowed under section 831(c) and this section, a net operating loss shall not be carried:

(1) To or from any taxable year for which the insurance company is not subject to the tax imposed by section 831(a) (or predecessor sections); or

(2) To any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 831(a) (or predecessor sections).

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.832–1 Gross income.

(a) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in § 1.831–1 the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets. The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year. In computing ''premiums earned on insurance contracts during the taxable year'' the amount of the unearned premiums shall include (1) life insurance reserves as defined in section 803(b) and § 1.803–1 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801, and (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the ''War Department Insurance Rating Plan,'' and which return premiums are therefore not earned premiums. In computing ''losses incurred'' the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for ''losses incurred'' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for ''losses incurred.''

(c) That part of the deduction for ''losses incurred'' which represents an adjustment to losses paid for salvage and reinsurance recoverable shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

§ 1.832–2 Deductions.

(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c)(10) and (12) include in addition certain deductions provided in sections 161, and 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, ''gross income'' shall mean gross income as defined in section 832(b)(1) and the allowable deductions shall be those allowed by section 832(c) with the exceptions and limitations set forth in section 172(d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), chapter 1 of the Code, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(c)(6) and the regulations thereunder. Insurance companies, other than mutual fire insurance companies described in § 1.831–1, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 823(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6867, 30 FR 15094, Dec. 12, 1965]

§ 1.832–3 Taxable years affected.

Sections 1.832–1 and 1.832–2 are applicable only to taxable years beginning after December 31, 1953, and before January 1, 1963, and ending after August 16, 1954, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 and the regulations thereunder before amendments. Sections 1.832–4, 1.832–5, and 1.832–6 are applicable only to taxable years beginning after December 31, 1962, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 as amended.

[T.D. 6681, 28 FR 11129, Oct. 17, 1963]

§ 1.832–4 Gross income.

(a)(1) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in section 831(a)(3)(A) the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Section 832(b)(1)(D) provides that in the case of a mutual fire or flood insurance company described in section 831(a)(3)(B), there shall be included in gross income an amount equal to 2 percent of the premiums earned during the taxable year on contracts described in section 831(a)(3)(B) after deduction of premium deposits returned or credited during such taxable year with respect to such contracts. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets.

(2) The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the

definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year.

(3) *Premiums earned.* The determination of premiums earned on insurance contracts during the taxable year begins with the insurance company's gross premiums written on insurance contracts during the taxable year, reduced by return premiums and premiums paid for reinsurance. Subject to the exceptions in sections 832(b)(7), 832(b)(8), and 833(a)(3), this amount is increased by 80 percent of the unearned premiums on insurance contracts at the end of the preceding taxable year, and is decreased by 80 percent of the unearned premiums on insurance contracts at the end of the current taxable year.

(4) *Gross premiums written*—(i) *In general.* Gross premiums written are amounts payable for insurance coverage. The label placed on a payment in a contract does not determine whether an amount is a gross premium written. Gross premiums written do not include other items of income described in section 832(b)(1)(C) (for example, charges for providing loss adjustment or claims processing services under administrative services or cost-plus arrangements). Gross premiums written on an insurance contract include all amounts payable for the effective period of the insurance contract. To the extent that amounts paid or payable with respect to an arrangement are not gross premiums written, the insurance company may not treat amounts payable to customers under the applicable portion of such arrangements as losses incurred described in section 832(b)(5).

(ii) *Items included.* Gross premiums written include—

(A) Any additional premiums resulting from increases in risk exposure during the effective period of an insurance contract;

(B) Amounts subtracted from a premium stabilization reserve to pay for insurance coverage; and

(C) Consideration in respect of assuming insurance liabilities under insurance contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction).

(5) *Method of reporting gross premiums written*—(i) *In general.* Except as otherwise provided under this paragraph (a)(5), an insurance company reports gross premiums written for the earlier of the taxable year that includes the effective date of the insurance contract or the year in which the company receives all or a portion of the gross premium for the insurance contract. The effective date of the insurance contract is the date on which the insurance coverage provided by the contract commences. The effective period of an insurance contract is the period over which one or more rates for insurance coverage are guaranteed in the contract. If a new rate for insurance coverage is guaranteed after the effective date of an insurance contract, the making of such a guarantee generally is treated as the issuance of a new insurance contract with an effective period equal to the duration of the new guaranteed rate for insurance coverage.

(ii) *Special rule for additional premiums resulting from an increase in risk exposure.* An insurance company reports additional premiums that result from an increase in risk exposure during the effective period of an insurance contract in gross premiums written for the taxable year in which the change in risk exposure occurs. Unless the increase in risk exposure is of temporary duration (for example, an increase in risk exposure under a workers' compensation policy due to seasonal variations in the policyholder's payroll), the company reports additional premiums resulting from an increase in risk exposure based on the remainder of the effective period of the insurance contract.

(iii) *Exception for certain advance premiums.* If an insurance company receives a portion of the gross premium for an insurance contract prior to the first day of the taxable year that includes the effective date of the contract, the company may report the advance premium (rather than the full amount of the gross premium for the contract) in gross premiums written for the taxable year in which the advance premium is received. An insurance company may adopt this method of reporting advance premiums only if the company's deduction for premium acquisition expenses for the taxable year in which the company receives the advance premium does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that reports an advance premium in gross premiums written under this paragraph (a)(5)(iii) takes into account the remainder of the gross premium written and premium acquisition expenses for the contract in the taxable year that includes the effective date of the contract. A company that adopts this method of reporting advance premiums must use the method for all contracts with advance premiums.

(iv) *Exception for certain cancellable accident and health insurance contracts with installment premiums.* If an insurance company issues or proportionally reinsures a cancellable accident and health insurance contract (other than a contract with an effective period that exceeds 12 months) for which the gross premium is payable in installments over the effective period of the contract, the company may report the installment premiums (rather than the total gross premium for the contract) in gross premiums written for the earlier of the taxable year in which the installment premiums are due under the terms of the contract or the year in which the installment premiums are received. An insurance company may adopt this method of reporting installment premiums for a cancellable accident and health insurance contract only if the company's deduction for premium acquisition expenses for the first taxable year in which an installment premium is due or received under the contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting installment premiums for a cancellable accident and health contract must use the method for all of its cancellable accident and health insurance contracts with installment premiums.

(v) *Exception for certain multi-year insurance contracts.* If an insurance company issues or proportionally reinsures an insurance contract, other than a contract described in paragraph (a)(5)(vi) of this section, with an effective period that exceeds 12 months, for which the gross premium is payable in installments over the effective period of the contract, the company may treat the insurance coverage provided under the multi-year contract as a series of separate insurance contracts. The first contract in the series is treated as having been written for an effective period of twelve months. Each subsequent contract in the series is treated as having been written for an effective period equal to the lesser of 12 months or the remainder of the period for which the rates for insurance coverage are guaranteed in the multi-year insurance contract. An insurance company may adopt this method of reporting premiums on a multi-year contract only if the company's deduction for premium acquisition expenses for each year of the multi-year contract does not exceed the limitation of paragraph (a)(5)(vii) of this section. A company that adopts this method of reporting premiums for a multi-year contract must use the method for all multi-year contracts with installment premiums.

(vi) *Exception for insurance contracts described in section 832(b)(7).* If an insurance company issues or reinsures the risks related to a contract described in section 832(b)(7), the company may report gross premiums written for the contract in the manner required by sections 803 and 811(a) for life insurance companies. An insurance company may adopt this method of reporting premiums on contracts described in section 832(b)(7) only if the company also determines the deduction for premium acquisition costs for the contract in accordance with section 811(a), as adjusted by the amount required to be taken into account under section 848 in connection with the net premiums of the contract. A company that adopts this method of reporting premiums for a contract described in section 832(b)(7) must use the method for all of its contracts described in that section.

(vii) *Limitation on deduction of premium acquisition expenses.* An insurance company's deduction for premium acquisition expenses (for example, commissions, state premium taxes, overhead reimbursements to agents or brokers, and other similar amounts) related to an insurance contract is within the limitation of this paragraph (a)(5)(vii) if—

(A) The ratio obtained by dividing the sum of the company's deduction for premium acquisition expenses related to the insurance contract for the taxable year and previous taxable years by the total premium acquisition expenses attributable to the insurance contract; does not exceed

(B) The ratio obtained by dividing the sum of the amounts included in gross premiums written with regard to the insurance contract for the taxable year and previous taxable years by the total gross premium written for the insurance contract.

(viii) *Change in method of reporting gross premiums.* An insurance company that adopts a method of accounting for gross premiums written and premium acquisition expenses described in paragraph (a)(5)(iii), (iv), (v), or (vi) of this section must continue to use the method to report gross premiums written and premium acquisition expenses unless the company obtains the consent of the Commissioner to change to a different method under section 446(e) and § 1.446–1(e).

(6) *Return premiums*—(i) *In general.* An insurance company's liability for return premiums includes amounts previously included in an insurance company's gross premiums written, which are refundable to a policyholder or ceding company, provided that the amounts are fixed by the insurance contract and do not depend on the experience of the insurance company or the discretion of its management.

(ii) *Items included.* Return premiums include amounts—

(A) Which were previously paid and become refundable due to policy cancellations or decreases in risk exposure during the effective period of an insurance contract;

(B) Which reflect the unearned portion of unpaid premiums for an insurance contract that is canceled or for which there is a decrease in risk exposure during its effective period; or

(C) Which are either previously paid and refundable or which reflect the unearned portion of unpaid premiums for an insurance contract, arising from the redetermination of a premium due to correction of posting or other similar errors.

(7) *Method of reporting return premiums.* An insurance company reports the liability for a return premium resulting from the cancellation of an insurance contract for the taxable year in which the contract is canceled. An insurance company reports the liability for a return premium attributable to a reduction in risk exposure under an insurance contract for the taxable year in which the reduction in risk exposure occurs.

(8) *Unearned premiums*—(i) *In general.* The unearned premium for a contract, other than a contract described in section 816(b)(1)(B), generally is the portion of the gross premium written that is attributable to future insurance coverage during the effective period of the insurance contract. However, unearned premiums held by an insurance company with regard to the net value of risks reinsured with other solvent companies (whether or not authorized to conduct business under state law) are subtracted from the company's unearned premiums. Unearned premiums also do not include any additional liability established by the insurance company on its annual statement to cover premium deficiencies. Unearned premiums do not include an insurance company's estimate of its liability for amounts to be paid or credited to a customer with regard to the expired portion of a retrospectively rated contract (retro credits). An insurance company's estimate of additional amounts payable by its customers with regard to the expired portion of a retrospectively rated contract (retro debits) cannot be subtracted from unearned premiums.

(ii) *Special rules for unearned premiums.* For purposes of computing ''premiums earned on insurance contracts during the taxable year'' under section 832(b)(4), the amount of unearned premiums includes—

(A) Life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (d));

(B) In the case of a mutual flood or fire insurance company described in section 832(b)(1)(D) (with respect to contracts described in that section), the amount of unabsorbed premium deposits that the company would be obligated to return to its policyholders at the close of the taxable year if all its insurance contracts were terminated at that time;

(C) In the case of an interinsurer or reciprocal underwriter that reports unearned premiums on its annual statement net of premium acquisition expenses, the unearned premiums on the company's annual statement increased by the portion of premium acquisition expenses allocable to those unearned premiums; and

(D) In the case of a title insurance company, its discounted unearned premiums (computed in accordance with section 832(b)(8)).

(9) *Method of determining unearned premiums.* If the risk of loss under an insurance contract does not vary significantly over the effective period of the contract, the unearned premium attributable to the unexpired portion of the effective period of the contract is determined on a pro rata basis. If the risk of loss varies significantly over the effective period of the contract, the insurance company may consider the pattern and incidence of the risk in determining the portion of the gross premium that is attributable to the unexpired portion of the effective period of the contract. An insurance company that uses a method of computing unearned premiums other than the pro rata method must maintain sufficient information to demonstrate that its method of computing unearned premiums accurately reflects the pattern and incidence of the risk for the insurance contract.

(10) *Examples.* The provisions of paragraphs (a)(4) through (a)(9) of this section are illustrated by the following examples:

Example 1. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. IC writes a casualty insurance contract that provides insurance coverage for a one-year period beginning on July 1, 2000 and ending on June 30, 2001. IC charges a $500 premium for the insurance contract, which may be paid either in full by the effective date of the contract or in quarterly installments over the contract's one year term. The policyholder selects the installment payment option. As of December 31, 2000, IC collected $250 of installment premiums for the contract.

(ii) The effective period of the insurance contract begins on July 1, 2000 and ends on June 30, 2001. For the taxable year ending December 31, 2000, IC includes the $500 gross premium, based on the effective period of the contract, in gross premiums written under section 832(b)(4)(A). IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250×.8) for the insurance contract at the end of the taxable year.

Example 2. (i) The facts are the same as *Example 1,* except that the insurance contract has a stated term of 5 years. On each contract anniversary date, IC may adjust the rate charged for the insurance coverage for the succeeding 12 month period. The amount of the adjustment in the charge for insurance coverage is not substantially limited under the insurance contract.

(ii) Under paragraph (a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based on the effective period for the contract. The effective period of the insurance contract is the period for which a rate for insurance coverage is guaranteed in the contract. Although the insurance contract issued by IC has a stated term of 5 years, a rate for insurance coverage is guaranteed only for a period of 12 months beginning with the contract's effective date and each anniversary date thereafter. Thus, for the taxable year ending December 31, 2000, IC includes the $500 gross premium for the 12 month period beginning with the contract's effective date in gross premiums written. IC's unearned premium with respect to the contract was $250 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $200 ($250×.8) for the insurance contract at the end of the taxable year.

Example 3. (i) The facts are the same as *Example 1,* except that coverage under the insurance contract begins on January 1, 2001 and ends on December 31, 2001. On December 15, 2000, IC collects the first $125 premium installment on the insurance contract. For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses, based on the insurance contract's $500 gross premium, are $80.

(ii) Under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the contract's $500 gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that IC's deduction for the premium acquisition expenses related to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). IC's deduction for premium acquisition expenses is within this limitation only if the ratio of the insurance contract's premium acquisition expenses deducted for the taxable year and any previous taxable year to the insurance contract's total premium acquisition expenses does not exceed the ratio of the amounts included in gross premiums written for the taxable year and any previous taxable year for the contract to the total gross premium written for the contract.

(iii) For the taxable year ended December 31, 2000, IC deducts $20 of premium acquisition expenses related to the insurance contract. This deduction represents 25% of the total premium acquisition expenses for the insurance contract ($20/$80 = 25%). This ratio does not exceed the ratio of the $125 advance premium to the insurance contract's $500 gross premium ($125/$500 = 25%). Therefore, under paragraph (a)(5)(iii) of this section, IC may elect to report only the $125 advance premium (rather than the $500 gross premium) in gross premiums written for the taxable year ending December 31, 2000. IC reports the balance of the gross premium for the insurance contract ($375) and deducts the remaining premium acquisition expenses ($60) for the insurance contract in the taxable year ending December 31, 2001.

Example 4. (i) The facts are the same as *Example 3,* except that for the taxable year ending December 31, 2000, IC deducts $60 of premium acquisition expenses related to the insurance contract.

(ii) For the taxable year ended December 31, 2000, IC deducted 75% of total premium acquisition expenses for the insurance contract ($60/$80 = 75%). This ratio exceeds the ratio of the $125 advance premium to the $500 gross premium ($125/$500 = 25%). Because IC's deduction for premium acquisition expenses allocable to the contract exceeds the limitation in paragraph (a)(5)(vii) of this section, paragraph (a)(5)(i) of this section requires IC to report the $500 gross premium in gross premiums written for the taxable year ending December 31, 2000. IC's unearned premium with respect to the contract was $500 as of December 31, 2000. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $400 ($500 × .8) for the insurance contract at the end of the taxable year.

Example 5. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On August 1, 2000, IC issues a one-year cancellable accident and health insurance policy to X, a corporation with 80 covered employees. The gross premium written for the insurance contract is $320,000. Premiums are payable in monthly installments. As of December 31, 2000, IC has collected $150,000 of installment premiums from X. For the taxable year ended December 31, 2000, IC has paid or incurred $21,000 of premium acquisition expenses related to the insurance contract. IC's total premium acquisition expenses for the insurance contract, based on the $320,000 gross premium, are $48,000.

(ii) Under paragraph (a)(5)(iv) of this section, IC may elect to report only the $150,000 of installment premiums (rather than the $320,000 estimated gross premium) in gross premiums written for the taxable year ended December 31, 2000, provided that its deduction for premium acquisition expenses allocable to the insurance contract does not exceed the limitation in paragraph (a)(5)(vii). For the taxable year ended December 31, 2000, IC deducts $21,000 of premium acquisition expenses related to the insurance contract, or 43.75% of total premium acquisition expenses for the insurance contract ($21,000/$48,000 = 43.75%). This ratio does not exceed the ratio of installment premiums to the gross premium for the contract ($150,000/$320,000 = 46.9%). Therefore, under paragraph (a)(5)(iv) of this section, IC may elect to report only $150,000 of installment premiums for the insurance contract (rather than $320,000 of gross premium) in gross premiums written for the taxable year ending December 31, 2000.

Example 6. (i) IC is a non-life insurance company which, pursuant to section 843, files its returns on a calendar year basis. On July 1, 2000, IC issues a one-year workers' compensation policy to X, an employer. The gross premium for the policy is determined by applying a monthly rate of $25 to each of X's employees. This rate is guaranteed for a period of 12 months, beginning with the effective date of the contract. On July 1, 2000, X has 1,050 employees. Based on the assumption that X's payroll would remain constant during the effective period of the contract, IC determines an estimated gross premium for the contract of $315,000 (1,050 × $25 × 12 = $315,000). The estimated gross premium is payable by X in equal monthly installments. At the end of each calendar quarter, the premiums payable under the contract are adjusted based on an audit of X's actual payroll during the preceding three months of coverage.

(ii) Due to an expansion of X's business in 2000, the actual number of employees covered under the contract during each month of the period between July 1, 2000 and December 31, 2000 is 1,050 (July), 1,050 (August), 1,050 (September), 1,200 (October), 1,200 (November), and 1,200 (December). The increase in the number of employees during the year is not attributable to a temporary or seasonal variation in X's business activities and is expected to continue for the remainder of the effective period of the contract.

(iii) Under paragraph (a)(5)(i) of this section, IC is required to report gross premiums written for the insurance contract based on the effective period of the contract. The effective period of X's contract is based on the 12 month period for which IC has guaranteed rates for insurance coverage. Under paragraph (a)(5)(ii), IC must also report the additional premiums resulting from the change in risk exposure under the contract for the taxable year in which the change in such exposure occurs. Unless the change in risk exposure is of temporary duration, the additional gross premiums are included in gross premiums written for the remainder of the effective period of the contract. Thus, for the taxable year ending December 31, 2000, IC reports gross premiums written of $348,750 with respect to the workers' compensation contract issued to X, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional gross premium attributable to the 150 employees added to X's payroll who will be covered during the last nine months of the contract's effective period (150×$25 (monthly premium)×9 = $33,750). IC's unearned premium with respect to the contract was $180,000 as of December 31, 2000, which consists of the sum of the remaining portion of the original gross premium ($315,000×6/12 = $157,500), plus the additional premiums resulting from the change in risk exposure ($33,750×6/9 = $22,500) that are allocable to the remaining six months of the contract's effective period. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $144,000 ($180,000×.8) for the insurance contract at the end of the taxable year.

Example 7. (i) The facts are the same as *Example 6*, except that the increase in the number of X's employees for the period ending December 31, 2000 is attributable to a seasonal variation in X's business activity.

(ii) Under paragraph (a)(5)(ii) of this section, for the taxable year ending December 31, 2000, IC reports gross premiums written of $326,500, consisting of the sum of the initial gross premium for the contract ($315,000) plus the additional premium attributable to the temporary increase in risk exposure during the taxable year (150×$25×3 = $11,250). The unearned premium that is allocable to the remaining six months of the effective period of the contract is $157,500. Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $126,000 ($157,500×.8) for the insurance contract at the end of the taxable year.

Example 8. (i) IC, a non-life insurance company, issues a noncancellable accident and health insurance contract (other than a qualified long-term care insurance contract, as defined in section 7702B(b)) to A, an individual, on July 1, 2000. The contract has an entry-age annual premium of $2,400, which is payable by A in equal monthly installments of $200 on the first day of each month of coverage. IC incurs agents' commissions, premium taxes, and other premium acquisition expenses equal to 10% of the gross premiums received for the contract. As of December 31, 2000, IC has collected $1,200 of installment premiums for the contract.

(ii) A noncancellable accident and health insurance contract is a contract described in section 832(b)(7). Thus, under paragraph (a)(5)(vi) of this section, IC may report gross premiums written in the manner required for life insurance companies under sections 803 and 811. Accordingly, for the taxable year ending December 31, 2000, IC may report gross premiums written of $1,200, based on the premiums actually received on the contract. Pursuant to section (a)(5)(vi) of this section, IC deducts a total of $28 of premium acquisition costs for the contract, based on the difference between the acquisition costs actually paid or incurred under section 811(a) ($1,200×.10 = $120) and the amount required to be taken into account under section 848 in connection with the net premiums for the contract ($1,200×.077 = $92).

(iii) Under paragraph (a)(8)(ii)(A) of this section, IC includes the amount of life insurance reserves (as defined in section 816(b), but computed in accordance with section 807(d) and sections 811(c) and (d)) in unearned premiums under section 832(b)(4)(B). Section 807(d)(3)(A)(iii) requires IC to use a two-year preliminary term method to compute the amount of life insurance reserves for a noncancellable accident and health insurance contract (other than a qualified long-term care contract). Under this tax reserve method, no portion of the $1,200 gross premium received by IC for A's contract is allocable to future insurance coverage. Accordingly, for the taxable year ending December 31, 2000, no life insurance reserves are included in IC's unearned premiums under section 832(b)(4)(B) with respect to the contract.

Example 9. (i) IC, a non-life insurance company, issues an insurance contract with a twelve month effective period for $1,200 on December 1, 2000. Immediately thereafter, IC reinsures 90% of its liability under the insurance contract for $900 with IC–2, an unrelated and solvent insurance company. On December 31, 2000, IC–2 has an $825 unearned premium with respect to the reinsurance contract it issued to IC. In computing its earned premiums, pursuant to section 832(b)(4)(B), IC–2 deducts $660 of unearned premiums ($825×.8) with respect to the reinsurance contract.

(ii) Under paragraph (a)(8)(i) of this section, unearned premiums held by an insurance company with regard to the net value of the risks reinsured in other solvent companies are deducted from the ceding company's unearned premiums taken into account for purposes of section 832(b)(4)(B). If IC had not reinsured 90% of its risks, IC's unearned premium for the insurance contract would have been $1,100 ($1,200×11/12) and IC would have deducted $880 ($1,100×.8) of unearned premiums with respect to such contract. However, because IC reinsured 90% of its risks under the contract with IC–2, as of December 31, 2000, the net value of the risks retained by IC for the remaining 11 months of the effective period of the contract is $110 ($1,100—$990). For the taxable year ending December 31, 2000, IC includes the $1,200 gross premium in its gross premiums written and deducts the $900 reinsurance premium paid to IC–2 under section 832(b)(4)(A). Pursuant to section 832(b)(4)(B), to determine its premiums earned, IC deducts $88 ($110×.8) for the insurance contract at the end of the taxable year.

(11) *Change in method of accounting*—(i) *In general.* A change in the method of determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section is a change in method of accounting for which the consent of the Commissioner is required under section 446(e) and § 1.446–1(e).

(ii) *Application.* For the first taxable year beginning after December 31, 1999, a taxpayer is granted consent of the Commissioner to change its method of accounting for determining premiums earned to comply with the provisions of paragraphs (a)(3) through (a)(10) of this section. A taxpayer changing its method of accounting in accordance with this section must follow the automatic change in accounting provisions of Rev. Proc. 99–49, 1999–52 I.R.B. 725 (see § 601.601(d)(2) of this chapter), except that—

(A) The scope limitations in section 4.02 of Rev. Proc. 99–49 shall not apply;

(B) The timely duplicate filing requirement in section 6.02(2) of Rev. Proc. 99–49 shall not apply; and

(C) If the method of accounting for determining premiums earned is an issue under consideration within the meaning of section 3.09 of Rev. Proc. 99–49 as of January 5, 2000, then section 7.01 of Rev. Proc. 99–49 shall not apply.

(12) *Effective date.* Paragraphs (a)(3) through (a)(11) of this section are applicable with respect to the determination of premiums earned for taxable years beginning after December 31, 1999.

(13) In computing the amount of unabsorbed premium deposits which a mutual fire or flood insurance company described in section 831(a)(3)(B) would be obligated to return to its policyholders at the close of its taxable year, the company must use its own schedule of unabsorbed premium deposit returns then in effect. A copy of the applicable schedule must be filed with the company's income tax return for each taxable year for which a computation based upon such schedule is made. In addition, a taxpayer making such a computation must provide the following information for each taxable year for which the computation is made:

(i) The amount of gross premiums received during the taxable year, and the amount of premiums paid for reinsurance during the taxable year, on the policies described in section 831(a)(3)(B) and on other policies;

(ii) The amount of insurance written during the taxable year under the policies described in section 831(a)(3)(B) and under other policies, and the amount of such insurance written which was reinsured during the taxable year. The information required under this subdivision shall only be submitted upon the specific request of the district director for a statement setting forth such information, and, if required, such statement shall be filed in the manner provided by this subparagraph or in such other manner as is satisfactory to the district director;

(iii) The amount of premiums earned during the taxable year on the policies described in section 831(a)(3)(B) and on other policies and the computations by which such amounts were determined, including sufficient information to support the taxpayer's determination of the amount of unearned premiums on premium deposit plan and other policies at the beginning and end of the taxable year, and the amount of unabsorbed premium deposits at the beginning and end of the taxable year on policies described in section 831(a)(3)(B).

The information required by this subparagraph shall be set forth in a statement attached to the taxpayer's income tax return for the taxable year for which such information is being provided. Such statement shall include the name and address of the taxpayer, and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year.

(14) In computing ''losses incurred'' the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) *Losses incurred.* Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for ''losses incurred'' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses. See section 846 for rules relating to the determination of discounted unpaid losses. These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The district director may require any insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for ''losses incurred.''

(c) *Losses incurred are reduced by salvage.* Under section 832(b)(5)(A), losses incurred are computed by taking into account losses paid reduced by salvage and reinsurance recovered, the change in discounted unpaid losses, and the change in estimated salvage and reinsurance recoverable. For purposes of section 832(b)(5)(A)(iii), estimated salvage recoverable includes all anticipated recoveries on account of salvage, whether or not the salvage is treated, or may be treated, as an asset for state statutory accounting purposes. Estimates of salvage recoverable must be based on the facts of each case and the company's experience with similar cases. Except as otherwise provided in guidance published by the Commissioner in the Internal Revenue Bulletin, estimated salvage recoverable must be discounted either—

(1) By using the applicable discount factors published by the Commissioner for estimated salvage recoverable; or

(2) By using the loss payment pattern for a line of business as the salvage recovery pattern for that line of business and by using the applicable interest rate for calculating unpaid losses under section 846(c). For purposes of section 832(b)(5)(A) and the regulations thereunder, the term ''salvage recoverable'' includes anticipated recoveries on account of subrogation claims arising with respect to paid or unpaid losses.

(d) *Increase in unpaid losses shown on annual statement in certain circumstances*—(1) *In general.* An insurance company that takes estimated salvage recoverable into account in determining the amount of its unpaid losses shown on its annual statement is allowed to increase its unpaid losses by the amount of estimated salvage recoverable taken into account if the company complies with the disclosure requirement of paragraph (d)(2) of this section. This adjustment shall not be used in determining under section 846(d) the loss payment pattern for a line of business.

(2) *Disclosure requirement.* (i) *In general.* A company described in paragraph (d)(1) of this section is allowed to increase the unpaid losses shown on its annual statement only if the company either—

(A) Discloses on its annual statement, by line of business and accident year, the extent to which estimated salvage recoverable is taken into account in computing the unpaid losses shown on the annual statement filed by the company for the calendar year ending with or within the taxable year of the company; or

(B) Files a statement on or before the due date of its Federal income tax return (determined without regard to extensions) with the appropriate state regulatory authority of each state to which the company is required to submit an annual statement. The statement must be contained in a separate document captioned ''DISCLOSURE CONCERNING LOSS RESERVES'' and must disclose, by line of business and accident year, the extent to which estimated salvage recoverable is taken into account in computing the unpaid losses shown on the annual statement filed by the company for the calendar year ending with or within the taxable year of the company.

(ii) *Transitional rule.* For a taxable year ending before December 31, 1991, a taxpayer is deemed to satisfy the disclosure requirement of paragraph (d)(2)(i)(B) of this section if the taxpayer files the statement described in paragraph (d)(2)(i)(B) of this section before March 17, 1992.

(3) *Failure to disclose in a subsequent year.* If a company that claims the increase permitted by paragraph (d)(1) of this section fails in a subsequent taxable year to make the disclosure described in paragraph (d)(2) of this section, the company cannot claim an increase under paragraph (d)(1) of this section in any subsequent taxable year without the consent of the Commissioner.

(e) *Treatment of estimated salvage recoverable*—(1) *In general.* An insurance company is required to take estimated salvage recoverable (including that which cannot be treated as an asset for state statutory accounting purposes) into account in computing the deduction for losses incurred. Except as provided in paragraph (e)(2)(iii) of this section, an insurance company must apply this method of accounting to estimated salvage recoverable for all lines of business and for all accident years.

(2) *Change in method of accounting*—(i) If an insurance company did not take estimated salvage recoverable into account as required by paragraph (c) of this section for its last taxable year beginning before January 1, 1990, taking estimated salvage recoverable into account as required by paragraph (c) of this section is a change in method of accounting.

(ii) If a company does not claim the deduction under section 11305(c)(3) of the 1990 Act, the company must take into account 13 percent of the adjustment that would otherwise be required under section 481 for pre-1990 accident years as a result of the change in accounting method. This paragraph (e)(2)(ii) applies only to an insurance company subject to tax under section 831.

(iii) If a company claims the deduction under section 11305(c)(3) of the 1990 Act and paragraph (f) of this section, the company must implement the change in method of accounting for estimated salvage recoverable for post-1989 taxable years pursuant to a ''cut-off'' method.

(3) *Rule for overestimates.* An insurance company is required under section 11305(c)(4) of the 1990 Act to include in gross income 87 percent of any amount (adjusted for discounting) by which the section 481 adjustment is overestimated. The rule is applied by comparing the amount of the section 481 adjustment (determined without regard to paragraph (e)(2)(ii) of this section and any discounting) to the sum of the actual salvage recoveries and remaining undiscounted estimated salvage recoverable that are attributable to losses incurred in accident years beginning before 1990. For any taxable year beginning after December 31, 1989, any excess of the section 481 adjustment over this sum (reduced by amounts treated as overestimates in prior taxable years pursuant to this paragraph (e)(3)) is an overestimate. To determine the amount to be included in income, it is necessary to discount this excess and multiply the resulting amount by 87 percent.

(f) *Special deduction*—(1) *In general.* Under section 11305(c)(3) of the 1990 Act, an insurance company may deduct an amount equal to 87 percent of the discounted amount of estimated salvage recoverable that the company took into account in determining the deduction for losses incurred under section 832(b)(5) in the last taxable year beginning before January 1, 1990. A company that claims the special deduction must establish to the satisfaction of the district director that the deduction represents only the discounted amount of estimated salvage recoverable that was actually taken into account by the company in computing losses incurred for that taxable year.

(2) *Safe harbor.* The requirements of paragraph (f)(1) of this section are deemed satisfied and the amount that the company reports as bona fide estimated salvage recoverable is not subject to adjustment by the district director, if—

(i) The company files with the insurance regulatory authority of the company's state of domicile, on or before September 16, 1991, a statement disclosing the extent to which losses incurred for each line of business reported on its 1989 annual statement were reduced by estimated salvage recoverable,

(ii) The company attaches a statement to its Federal income tax return filed for the first taxable year beginning after December 31, 1989, agreeing to apply the special rule for overestimates under section 11305(c)(4) of the 1990 Act to the amount of estimated salvage recoverable for which it has taken the special deduction, and

(iii) In the case of a company that is a member of a consolidated group, each insurance company subject to tax under section 831 that is included in the consolidated group complies with paragraph (f)(2)(ii) of this section with respect to its special deduction, if any.

(3) *Limitations on special deduction*—(i) The special deduction under section 11305(c)(3) of the 1990 Act is available only to an insurance company subject to tax under section 831.

(ii) An insurance company that claimed the benefit of the ''fresh start'' with respect to estimated salvage recoverable under section 1023(e) of the Tax Reform Act of 1986 may not claim the special deduction allowed by section 11305(c)(3) of the 1990 Act to the extent of the estimated salvage recoverable for which a fresh start benefit was previously claimed.

(iii) A company that claims the special deduction is precluded from also claiming the section 481 adjustment provided in paragraph (e)(2)(ii) of this section for pre-1990 accident years.

(g) *Effective date.* Paragraphs (b) through (f) of this section are effective for taxable years beginning after December 31, 1989.

[T.D. 6681, 28 FR 11129, Oct. 17, 1963, as amended by T.D. 8171, 53 FR 118, Jan. 5, 1988; T.D. 8293, 55 FR 9425, Mar. 14, 1990. Redesignated and amended by T.D. 8390, 57 FR 3132, Jan. 28, 1992; 57 FR 6353, Feb. 24, 1992; T.D. 8857, 65 FR 706, Jan. 6, 2000]

§ 1.832–5 Deductions.

(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c)(10) and (12) include in addition certain deductions provided in sections 161, and 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, ''gross income'' shall mean gross income as defined in section 832(b)(1) and the allowable deductions shall be those allowed by section 832(c) with the exceptions and limitations set forth in section 172(d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), chapter 1 of the Code, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(c)(6) and the regulation thereunder. Insurance companies, other than mutual fire insurance companies described in section 831(a)(3)(A) and the regulations thereunder, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual insurance companies. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(f)(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.

[T.D. 6681, 28 FR 11130, Oct. 17, 1963, as amended by T.D. 6867, 30 FR 15094, Dec. 7, 1965]

§ 1.832–6 Policyholders of mutual fire or flood insurance companies operating on the basis of premium deposits.

For purposes of determining his taxable income for any taxable year, a taxpayer insured by a mutual fire or flood insurance company under a policy for which the premium deposit is the same regardless of the length of the term for which the policy is written, and who is entitled to have returned or credited to his on the cancellation or expiration of such policy the unabsorbed portion of the premium deposit not required for losses, expenses, or establishment of reserves, may, if such amount is otherwise deductible under this chapter, deduct so much of his premium deposit as was absorbed by the company during the taxpayer's taxable year. The amount of the premium deposit absorbed during the taxpayer's taxable year shall be determined in accordance with the schedule of unabsorbed premium deposit returns in effect for the company during such taxable year. If the taxpayer is unable to determine the applicable rate of absorption in effect during his taxable year, he shall compute his deduction on the basis of the rate of absorption in effect at the end of the company's taxable year which next preceded the end of the taxpayer's taxable year. In such a case, an appropriate adjustment will be made upon the final determination of the rate of absorption applicable to the taxable year.

[T.D. 6681, 28 FR 11130, Oct. 17, 1963]

§ 1.832–7T Treatment of salvage and reinsurance in computing "losses incurred" deduction, taxable years beginning before January 1, 1990 (temporary).

(a) In computing ''losses incurred'' the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for ''losses incurred'' which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for ''losses incurred''.

(c) That part of the deduction for ''losses incurred'' which represents an adjustment to losses paid for salvage and reinsurance recoverable shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

(d) This section is effective for taxable years beginning before January 1, 1990.

[T.D. 8266, 54 FR 38970, Sept. 22, 1989; T.D. 8293, 55 FR 9425, Mar. 14, 1990]

§ 1.846–0 Outline of provisions.

The following is a list of the headings in §§ 1.846–1 through 1.846–4.

§ 1.846–1 Application of discount factors.

(a) In general.
(1) Rules.
(2) Examples.
(3) Increase in discounted unpaid losses shown on the annual statement.
(4) Increase in unpaid losses which take into account estimated salvage recoverable.
(b) Applicable discount factors.
(1) In general.
(i) Discount factors published by the Service.
(ii) Composite discount factors.
(iii) Annual statement changes.
(2) Title insurance company reserves.
(3) Reinsurance business.
(i) Proportional reinsurance for accident years after 1987.
(ii) Non-proportional reinsurance.
(A) Accident years after 1991.
(B) Accident years 1988 through 1991.
(iii) Reinsurance for accident years before 1988.
(iv) 90 percent exception.
(4) International business.
(5) Composite discount factors.

§ 1.846–2 Election by taxpayer to use its own historical loss payment pattern.

(a) In general.
(b) Eligible line of business.
(1) In general.
(2) Other published guidance.
(3) Special rule for 1987 determination year.
(c) Anti-abuse rule.

§ 1.846–3 Fresh start and reserve strengthening.

(a) In general.
(b) Applicable discount factors.
(1) Calculation of beginning balance.
(2) Example.
(c) Rules for determining the amount of reserve strengthening.
(1) In general.
(2) Accident years after 1985.
(i) In general.
(ii) Hypothetical unpaid loss reserve.
(3) Accident years before 1986.
(i) In general.
(ii) Exceptions.
(iii) Certain transactions deemed to be reinsurance assumed (ceded) in 1986.
(d) Section 845.
(e) Treatment of reserve strengthening.
(f) Examples.

§ 1.846–4 Effective date.

[T.D. 8433, 57 FR 40843, Sept. 8, 1992; 57 FR 48563, Oct. 27, 1992]

§ 1.846–1 Application of discount factors.

(a) *In general*—(1) *Rules.* A separate series of discount factors are computed for, and applied, to undiscounted unpaid losses attributable to each accident year of each line of business shown on the annual statement (as defined by section 846(f)(3)) filed by that taxpayer for the calendar year ending with or within the taxable year of the taxpayer. See § 1.832–4(b) relating to the determination of unpaid losses. Paragraph (b) of this section provides rules relating to applicable discount factors and § 1.846–3(b) contains guidance relating to discount factors applicable to accident years prior to the 1987 accident year. Once a taxpayer applies a series of discount factors to unpaid losses attributable to an accident year of a line of business, that series of discount factors must be applied to discount the unpaid losses for that accident year for that line of business for all future taxable years. The discount factors cannot be changed to reflect a change in the taxpayer's loss payment pattern during a subsequent year or to reflect a different interest rate assumption. However, discount factors may be changed for taxpayers who elect to use their own historical loss payment pattern, if information upon which the pattern is based is adjusted upon examination by the district director.

(2) *Examples.* The following examples illustrate the principles of paragraph (a)(1) of this section:

Example 1. A taxpayer discounts unpaid losses attributable to all accident years prior to 1992 using discount factors published by the Service. In 1992, the taxpayer elects, under §1.846–2, to compute discount factors using its own historical loss payment pattern. The taxpayer must continue to discount unpaid losses attributable to pre-1992 accident years using the discount factors published for those accident years by the Service.

Example 2. On its annual statements through 1987, a taxpayer did not allocate unpaid losses attributable to proportional reinsurance to the line of business associated with the risks being reinsured. Beginning with the 1988 annual statement, the taxpayer allocated those losses for all accident years to the line of business being reinsured. The taxpayer must continue to discount the unpaid losses attributable to proportional reinsurance from pre-1988 accident years using the discount factors that were used in determining tax reserves for the 1987 tax year. (See paragraph (b)(3) of this section for rules relating to the application of discount factors to reinsurance unpaid losses.)

(3) *Increase in discounted unpaid losses shown on the annual statement.* If the amount of unpaid losses shown on the annual statement is determined on a discounted basis, and the extent to which the unpaid losses were discounted can be determined on the basis of information disclosed on or with the annual statement, the amount of the unpaid losses to which the discount factors are applied shall be determined without regard to any reduction attributable to the discounting reflected on the annual statement.

(4) *Increase in unpaid losses which take into account estimated salvage recoverable.* If the amount of unpaid losses shown on the annual statement reflects a reduction for estimated salvage recoverable and the extent to which the unpaid losses were reduced by estimated salvage recoverable is appropriately disclosed as required by §1.832–4(d)(2), the amount of unpaid losses shall be determined without regard to the reduction for salvage recoverable.

(b) *Applicable discount factors*—(1) *In general.* Except as otherwise provided in section 846(f)(6) (relating to certain accident and health lines of business), in §1.846–2 (relating to a taxpayer's election to use its own historical loss payment pattern), in this paragraph (b), or in other guidance published in the Internal Revenue Bulletin, the following factors must be used—

(i) *Discount factors published by the Service.* If the Service has published discount factors for a line of business, a taxpayer must discount unpaid losses attributable to that line by applying those discount factors; and

(ii) *Composite discount factors.* If the Service has not published discount factors for a line of business, a taxpayer must discount unpaid losses attributable to that line by applying composite discount factors.

(iii) *Annual statement changes.* If the groupings of individual lines of business on the annual statement changes, taxpayers must discount the unpaid losses on the resulting lines of business with the discounting patterns that would have applied to those unpaid losses based on their annual statement classification prior to the change.

(2) *Title insurance company reserves.* A title insurance company may only take into account case reserves (relating to claims which have been reported to the insurance company). Unless the Service publishes other guidance, the reserves must be discounted using the ''Miscellaneous Casualty'' discount factors published by the Service. Section 832(b)(8) provides rules for determining the discounted unearned premiums of a title insurance company.

(3) *Reinsurance business*—(i) *Proportional reinsurance for accident years after 1987.* For the 1988 accident year and subsequent accident years, unpaid losses for proportional reinsurance must be discounted using discount factors applicable to the line of business to which those unpaid losses are allocated as required on the annual statement.

(ii) *Non-proportional reinsurance*—(A) *Accident years after 1991.* For the 1992 accident year and subsequent accident years, unpaid losses for non-proportional reinsurance must be discounted using the applicable discount factors published by the Service for the appropriate reinsurance line of business.

(B) *Accident years 1988 through 1991.* For the 1988, 1989, 1990, and 1991 accident years unpaid losses for non-proportional reinsurance must be discounted using composite discount factors.

(iii) *Reinsurance for accident years before 1988.* If on its annual statement a taxpayer does not allocate unpaid losses to the applicable line of business for proportional or nonproportional reinsurance attributable to the 1987 accident year or a prior accident year, those losses must be discounted using composite discount factors. If on its annual statement a taxpayer allocates to the underlying line of business reinsurance unpaid losses that are attributable to the 1987 accident year or a prior accident year, those losses must be discounted using discount factors applicable to the underlying line of business.

(iv) *90 percent exception.* For purposes of § 1.846–1(b)(3) (ii) and (iii), if more than 90 percent of all the unallocated losses of a taxpayer for an accident year relate to one underlying line of business, the taxpayer must discount all unallocable reinsurance unpaid losses attributable to that accident year using the discount factors published by the Service for the underlying line of business.

(4) *International business.* For any accident year, unpaid losses which are attributable to international business must be discounted using composite discount factors unless more than 90 percent of all losses for that accident year relate to one underlying line of business. If more than 90 percent of all losses for an accident year relate to one underlying line of business, the taxpayer must discount the losses attributable to that accident year using discount factors published by the Service for the underlying line of business.

(5) *Composite discount factors.* For purposes of the regulations under section 846, ''composite discount factors'' means the series of discount factors published annually by the Service determined on the basis of the appropriate composite loss payment pattern.

[T.D. 8433, 57 FR 40844, Sept. 8, 1992]

§ 1.846–2 Election by taxpayer to use its own historical loss payment pattern.

(a) *In general.* If a taxpayer has one or more eligible lines of business in a determination year, the taxpayer may elect on the taxpayer's timely filed Federal income tax return for the determination year to discount unpaid losses using its own historical loss payment pattern instead of the industry-wide pattern determined by the Secretary. A taxpayer making the election must use its own historical loss payment pattern in discounting unpaid losses for each line of business that is an eligible line of business in that determination year. The election applies to accident years ending with the determination year and to each of the four succeeding accident years. If a taxpayer makes the election for the 1987 determination year, the taxpayer must use its 1987 loss payment pattern (determined by reference to its 1985 annual statement) to discount unpaid losses attributable to all accident years prior to 1988.

(b) *Eligible line of business*—(1) *In general.* A line of business is an eligible line of business in a determination year if, on the most recent annual statement filed by the taxpayer before the beginning of that determination year, the taxpayer reports losses and loss expenses incurred (in Schedule P, part 1, column 24 of the 1990 annual statement or comparable location in an earlier or subsequently revised blank) for at least the number of accident years for which losses and loss expenses incurred for that line of business are required to be separately reported on that annual statement. For example, for the 1987 determination year, the 1985 annual statement is used. The annual statement to be used to determine eligibility in subsequent determination years is the annual statement for each fifth year after 1985 (e.g., 1990, 1995, etc.).

(2) *Other published guidance.* A line of business is also an eligible line of business for purposes of the election if the

line is an eligible line under requirements published for this purpose in the Internal Revenue Bulletin.

(3) *Special rule for 1987 determination year.* A line of business is an eligible line of business in the 1987 determination year if it is eligible under paragraph (b) (1) or (2) of this section, or if on the most recent annual statement filed by the taxpayer before the beginning of the 1987 determination year, the taxpayer reports written premiums for the line of business for at least the number of accident years that unpaid losses for that line of business are required to be separately reported on that annual statement.

(c) *Anti-abuse rule.* To prevent avoidance of the requirement that the election to use historical loss payment patterns apply to all eligible lines of business of a taxpayer, the district director may—

(1) Nullify a taxpayer's election to compute discounted unpaid losses based on its historical loss payment pattern;

(2) Adjust a taxpayer's historical loss payment pattern; or

(3) Make other proper adjustments.

[T.D. 8433, 57 FR 40845, Sept. 8, 1992]

§ 1.846–3 Fresh start and reserve strengthening.

(a) *In general.* Section 1023(e) of the Tax Reform Act of 1986 (''the 1986 Act'') provides rules relating to fresh start and reserve strengthening. For purposes of section 1023(e) of the 1986 Act, a taxpayer must discount its unpaid losses as of the end of the last taxable year beginning before January 1, 1987. The excess of undiscounted unpaid losses over discounted unpaid losses as of that time is not required to be included in income, except (as provided in paragraph (e) of this section) to the extent of any ''reserve strengthening'' in a taxable year beginning in 1986. The exclusion from income of this excess is known as ''fresh start.'' The amount of fresh start is, however, included in earnings and profits for the first taxable year beginning after December 31, 1986.

(b) *Applicable discount factors*—(1) *Calculation of beginning balance.* For purposes of section 1023(e) of the 1986 Act, a taxpayer discounts unpaid losses as of the end of the last taxable year beginning before January 1, 1987—

(i) By using the same discount factors that are used in the succeeding taxable year to discount unpaid losses attributable to the 1987 accident year and prior accident years (see section 1023(e)(2) of the 1986 Act); and

(ii) By applying those discount factors as if the 1986 accident year were the 1987 accident year.

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

Example. X, a calendar year taxpayer, does not make an election in 1987 to use its own historical loss payment pattern. When X computes discounted unpaid losses for its last taxable year beginning before January 1, 1987, the discount factor for AY+0 published in Rev. Rul. 87–34, 1987–1 C.B. 168, must be applied to unpaid losses attributable to the 1986 accident year; the discount factor for AY+1 is applied to unpaid losses attributable to the 1985 accident year; etc.

(c) *Rules for determining the amount of reserve strengthening (weakening)*—(1) *In general.* The amount of reserve strengthening (weakening) is the amount that is determined under paragraph (c)(2) or (3) to have been added to (subtracted from) an unpaid loss reserve in a taxable year beginning in 1986. For purposes of section 1023(e)(3)(B) of the 1986 Act, the amount of reserve strengthening (weakening) must be determined separately for each unpaid loss reserve by applying the rules of this paragraph (c). This determination is made without regard to the reasonableness of the amount of the unpaid loss reserve and without regard to the taxpayer's discretion, or lack thereof, in establishing the amount of the unpaid loss reserve. The amount of reserve strengthening for an unpaid loss reserve may not exceed the amount of the reserve, including any undiscounted strengthening amount, as of the end of the last taxable year beginning before January 1, 1987. For purposes of this section, an ''unpaid loss reserve'' is the aggregate of the unpaid loss estimate for losses (whether or not reported) incurred in an accident year of a line of business.

(2) *Accident years after 1985*—(i) *In general.* The amount of reserve strengthening (weakening) for an unpaid loss

reserve for an accident year after 1985 is the amount by which that reserve at the end of the last taxable year beginning in 1986 exceeds (is less than) a hypothetical unpaid loss reserve.

(ii) *Hypothetical unpaid loss reserve.* For purposes of this paragraph (c)(2), the term ''hypothetical unpaid loss reserve'' means a reserve computed for losses the estimates of which were included, at the end of the last taxable year beginning in 1986, in the unpaid loss reserve for which reserve strengthening (weakening) is being determined. The hypothetical unpaid loss reserve must be computed using the same assumptions, other than the assumed interest rates in the case of reserves determined on a discounted basis for annual statement reporting purposes, that were used to determine the 1985 accident year reserve, if any, for the line of business for which the hypothetical reserve is being computed. If there was no 1985 accident year reserve for that line of business, the hypothetical unpaid loss reserve is the reserve, at the end of the last taxable year beginning in 1986, for which reserve strengthening (weakening) is being determined (and thus there is no reserve strengthening or weakening).

(3) *Accident years before 1986*—(i) *In general.* For each taxable year beginning in 1986, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 is the amount by which the reserve at the end of that taxable year exceeds (is less than)—

(A) The reserve at the end of the immediately preceding taxable year; reduced by

(B) Claims paid and loss adjustment expenses paid (''loss payments'') in the taxable year beginning in 1986 with respect to losses that are attributable to the reserve. The amount by which a reserve is reduced as a result of reinsurance ceded during a taxable year beginning in 1986 is treated as a loss payment made in that taxable year.

(ii) *Exceptions.* Notwithstanding paragraph (c)(3)(i) of this section, the amount of reserve strengthening (weakening) for an unpaid loss reserve for an accident year before 1986 does not include—

(A) An amount added to the reserve in a taxable year beginning in 1986 as a result of a loss reported to the taxpayer from a mandatory state or federal assigned risk pool if the amount of the loss reported is not discretionary with the taxpayer; or

(B) Payments made with respect to reinsurance assumed during a taxable year beginning in 1986 or amounts added to the reserve to take into account reinsurance assumed for a line of business during a taxable year beginning in 1986, but only to the extent that the amount does not exceed the amount of a hypothetical reserve for the reinsurance assumed. The amount of the hypothetical reserve is determined using the same assumptions (other than the assumed interest rates) that were used to determine a reserve for reinsurance assumed for the line of business in a taxable year beginning in 1985.

(iii) *Certain transactions deemed to be reinsurance assumed (ceded) in 1986.* For purposes of this paragraph (c)(3), reinsurance assumed (ceded) in a taxable year beginning in 1985 is treated as assumed (ceded) during the succeeding taxable year if the appropriate unpaid loss reserve is not adjusted to take into account the reinsurance transaction until that succeeding taxable year.

(d) *Section 845.* Any reinsurance transaction that has as one of its purposes the avoidance of the reserve strengthening limitation is subject to section 845.

(e) *Treatment of reserve strengthening.* The fresh start provision of section 1023(e)(3)(A) of the 1986 Act does not apply to the portion of the taxpayer's unpaid losses attributable to reserve strengthening. Thus, the difference between the undiscounted unpaid losses attributable to reserve strengthening and the discounted unpaid losses attributable to reserve strengthening must be included in income and, therefore, included in earnings and profits for the first taxable year beginning after December 31, 1986. The amount that a taxpayer must include in income for its first taxable year beginning after December 31, 1986, as a result of reserve strengthening is equal to the excess (if any) of—

(1) The sum of each amount of reserve strengthening multiplied by the difference between 100 percent and the discount factor that, under paragraph (b) of this section, is applicable to the unpaid loss reserve which was strengthened; over

(2) The sum of each reserve weakening multiplied by the difference between 100 percent and the discount factor that, under paragraph (b) of this section, is applicable to the unpaid loss reserve which was weakened.

(f) *Examples.* The following examples illustrate the principles of this section. For purposes of these examples, it is assumed that the taxpayers are property and casualty insurance companies that in 1987 did not elect to use their own historical loss payment patterns.

Example 1. (i) As of the end of 1985, X, a calendar year taxpayer, had undiscounted unpaid losses of $1,000,000 in the workers' compensation line of business for the 1984 accident year. The same reserve had undiscounted unpaid losses of $900,000 at the end of 1986. During 1986, X's loss payments for this reserve were $300,000. Accordingly, under paragraph (c)(3)(i) of this section, X has a reserve strengthening of $200,000 ($900,000–($1,000,000–$300,000)).

(ii) This was X's only reserve strengthening or weakening. Thus, under paragraph (e) of this section, for 1987 X must include in income $54,361.40 ($200,000×(100% − 72.8193%)). The factor of 72.8193% is the AY+2 factor from the workers' compensation series of discount factors published in Rev. Rul. 87–34, 1987–1 C.B. 168.

Example 2. The facts are the same as in *Example 1,* except that X's 1986 loss payments for the reserve were $1,100,000. If only paragraph (c)(3)(i) of this section were applied, X would have a $1,000,000 reserve strengthening ($900,000–($1,000,000–$1,100,000)). Under paragraph (c)(1) of this section, however, the amount of reserve strengthening for the reserve is limited to the amount of the reserve at the end of 1986. Accordingly, X has a reserve strengthening of $900,000 and for 1987 must include in income $244,626.30 ($900,000×(100% − 72.1893%)).

Example 3. (i) As of the end of 1985, Y, a calendar year taxpayer, had undiscounted unpaid losses of $1,000,000 in the auto physical damage line of business for the 1985 accident year. The same reserve included undiscounted unpaid losses of $600,000 at the end of 1986. During 1986, Y had loss payments of $300,000 for this line of business. Under paragraph (c)(3)(i) of this section Y has a $100,000 reserve weakening $600,000–($1,000,000–$300,000)).

(ii) Under paragraph (e) of this section, the only effect of the reserve weakening is to reduce the amount that Y is required to include in income as a result of any strengthening of another reserve.

Example 4. The facts are the same as in *Example 1* except that X also has a $100,000 reserve weakening for the 1985 accident year in its auto physical damage line of business. Under paragraph (b) of this section, the reserve discount factor for the reserve is 93.3400, the AY+1 factor from the auto physical damage series of discount factors published in Rev. Rul. 87–34. Thus, under paragraph (e) of this section, the amount that X is required to include in income in 1987 is reduced by $6,660 ($100,000×(100% − 93.3400%)), resulting in an amount of $47,761.40 ($54,361.40 − $6,660).

Example 5. (i) At the end of 1985, Z, a calendar year taxpayer, had undiscounted unpaid losses of $1,000,000 in the workers' compensation line of business for the 1984 accident year. On May 1, 1986, Z ceded $130,000 of the reserve to an unrelated reinsurer. Z added $250,000 to the 1985 year end reserve to take into account workers' compensation risks for the 1984 accident year that Z assumed in a reinsurance transaction on September 1, 1986. Z had $230,000 of 1986 loss payments related to the 1984 accident year of its workers' compensation line, $60,000 of which was attributable to the reinsurance assumed by Z. At the end of 1986, Z's reserve for the workers' compensation line for the 1984 accident year was $1,100,000.

(ii) If only paragraph (c)(3)(i) of this section were applied, Z would have a $460,000 reserve strengthening ($1,100,000 − ($1,000,000 − $230,000 − $130,000)). Under paragraph (c)(3)(ii)(B) of this section, however, reserve strengthening does not include the $250,000 that Z added to the reserve to take into account the reinsurance assumed. Also, none of the $60,000 of loss payments attributable to the reinsurance assumed in 1986 are taken into account. Accordingly, Z has $150,000 of reserve strengthening ($460,000–$250,000–$60,000). If this is Z's only reserve strengthening or weakening, then the amount that Z must include in income for 1987 under paragraph (e) of this section is $40,771.05 ($150,000×(100% − 72.8193%)). The factor of 72.8193% is the AY+2 factor from the workers' compensation series of discount factors published in Rev. Rul. 87–34.

Example 6. (i) X was a calendar year taxpayer before July 1, 1986, the date on which X became a member of an affiliated group of corporations that files a consolidated return with a June 30 year end. Thus, X had two taxable years beginning in 1986: a short taxable year ending June 30, 1986, and a fiscal taxable year ending June 30, 1987.

(ii) As of the end of 1985, X had undiscounted unpaid losses of $800,000 in the automobile liability line of business for the

1983 accident year. At the end of the short taxable year, X had reserves of $700,000 of undiscounted unpaid losses, and on June 30, 1987, had reserves of $600,000 of undiscounted unpaid losses. During the short taxable year, ending June 30, 1986, X's loss payments for this reserve were $120,000. During the taxable year ending June 30, 1987, X's loss payments for this reserve were $180,000. Under paragraph (c)(3)(i) of this section, X has a $100,000 reserve strengthening: of which $20,000 ($700,000 − ($800,000 − $120,000)) is attributable to the short taxable year ending June 30, 1986 and $80,000 ($600,000 − ($700,000 − $180,000)) is attributable to the taxable year ending June 30, 1987.

(iii) The amount of reserve strengthening for this line of business is determined pursuant to the principles of paragraph (c)(2) of this section.

[T.D. 8433, 57 FR 40845, Sept. 8, 1992; 57 FR 48563, Oct. 27, 1992; 57 FR 57531, Dec. 4, 1992]

§ 1.846–4 Effective date.

Sections 1.846–1 through Sections 1.846–3 apply to taxable years beginning after December 31, 1986.

[T.D. 8433, 57 FR 40847, Sept. 8, 1992]

§ 1.848–0 Outline of regulations under section 848.

This section lists the paragraphs in §§ 1.848–1 through 1.848–3.

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1.848–2 Determination of net premiums.

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(A) In general.
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(5) Example.
(d) Amounts excluded from the gross amount of premiums and other consideration.
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(2) Net consideration determined by a ceding company.
(i) In general.
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1.848–3 Interim rules for certain reinsurance agreements.

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(1) Assumption reinsurance.

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(4) Termination payments.
(5) Modified coinsurance agreements.
(d) Examples.

[T.D. 8456, 57 FR 61818, Dec. 29, 1992]

§ 1.848–1 Definitions and special provisions.

(a) *Scope and effective date.* The definitions and special provisions in this section apply solely for purposes of determining specified policy acquisition expenses under section 848 of the Internal Revenue Code, this section, and §§ 1.848–2 and 1.848–3. Unless otherwise specified, the rules of this section are effective for the taxable years of an insurance company beginning after November 14, 1991.

(b) *Specified insurance contract*—(1) *In general.* A ''specified insurance contract'' is any life insurance contract, annuity contract, noncancellable or guaranteed renewable accident and health insurance contract, or combination contract. A reinsurance agreement that reinsures the risks under a specified insurance contract is treated in the same manner as the reinsured contract.

(2) *Exceptions*—(i) *In general.* A ''specified insurance contract'' does not include any pension plan contract (as defined in section 818(a)), flight insurance or similar contract, or qualified foreign contract (as defined in section 807(e)(4)).

(ii) *Reinsurance of qualified foreign contracts.* The exception for qualified foreign contracts does not apply to reinsurance agreements that reinsure qualified foreign contracts.

(c) *Life insurance contract.* A ''life insurance contract'' is any contract—

(1) Issued after December 31, 1984, that qualifies as a life insurance contract under section 7702(a) (including an endowment contract as defined in 7702(h)); or

(2) Issued prior to January 1, 1985, if the premiums on the contract are reported as life insurance premiums on the insurance company's annual statement (or could be reported as life insurance premiums if the company were required to file the annual statement for life and accident and health companies).

(d) *Annuity contract.* An ''annuity contract'' is any contract (other than a life insurance contract as defined in paragraph (c) of this section) if amounts received under the contract are subject to the rules in section 72(b) or section 72(e) (determined without regard to section 72(u)). The term ''annuity contract'' also includes a contract that is a qualified funding asset under section 130(d).

(e) *Noncancellable accident and health insurance contract.* The term ''noncancellable accident and health insurance contract'' has the same meaning for purposes of section 848 as the term has for purposes of section 816(b).

(f) *Guaranteed renewable accident and health insurance contract.* The term ''guaranteed renewable accident and health insurance contract'' has the same meaning for purposes of section 848 as the term has for purposes of section 816(e).

(g) *Combination contract*—(1) *Definition.* A ''combination contract'' is a contract (other than a contract described in section 848(e)(3)) that provides two or more types of insurance coverage, at least one of which if offered separately would be a life insurance contract, an annuity contract, or a noncancellable or guaranteed renewable accident and health insurance contract.

(2) *Treatment of premiums on a combination contract*—(i) *In general.* If the premium allocable to each type of insurance coverage is separately stated on the insurance company's annual statement (or could be separately stated if the insurance company were required to file the annual statement for life and accident and health companies), the premium allocable to each type of insurance coverage in a combination contract is subject to the capitalization rate, if any, that would apply if that coverage was provided in a separate contract. If the premium allocable to each type of insurance coverage in a combination contract is not separately stated, the entire premium is subject to the highest capitalization percentage applicable to any of the coverages provided.

(ii) *De minimis premiums.* For purposes of this paragraph (g)(2)—

(A) A de minimis premium is not required to be separately stated;

(B) In determining the highest capitalization percentage applicable to a combination contract, the coverage to which a de minimis premium is allocable is disregarded;

(C) If the separate statement requirement of this paragraph (g)(2) is satisfied, a de minimis premium is treated in accordance with its characterization on the insurance company's annual statement; and

(D) Whether a premium for an insurance coverage is de minimis is determined by comparing that premium with the aggregate of the premiums for the combination contract. A premium that is not more than 2 percent of the premium for the entire contract is considered de minimis. Whether a premium that is more than 2 percent is de minimis is determined based on all the facts and circumstances.

(3) *Example.* The principles of this paragraph (g) are illustrated by the following example.

Example. A life insurance company (L1) issues a contract to an employer (X) which provides cancellable accident and health insurance coverage and group term life insurance coverage to X's employees. L1 charges a premium of $1,000 for the contract, $950 of which is attributable to the cancellable accident and health insurance coverage and $50 of which is attributable to the group term life insurance coverage. On its annual statement, L1 reports the premiums attributable to the accident and health insurance coverage separately from the premiums attributable to the group term life insurance coverage. The contract issued by L1 is a combination contract as defined in paragraph (g)(1) of this section. Pursuant to paragraph (g)(2)(i) of this section, only the premiums attributable to the group term life insurance coverage ($50) are subject to the provisions of section 848. The premiums attributable to the cancellable accident and health insurance coverage ($950) are not subject to the provisions of section 848.

(h) *Group life insurance contract*—(1) *In general.* A life insurance contract (as defined in paragraph (c) of this section) is group life insurance contract if—

(i) The contract is a group life insurance contract under the applicable law;

(ii) The coverage is provided under a master contract issued to the group policyholder, which may be a trust, trustee, or agent;

(iii) The premiums on the contract are reported either as group life insurance premiums or credit life insurance premiums on the insurance company's annual statement (or could be reported as group life insurance premiums or credit life insurance premiums if the company were required to file the annual statement for life and accident and health companies);

(iv) The group affiliation requirement of paragraph (h)(2) of this section is satisfied;

(v) The premiums on the contract are determined on a group basis within the meaning of paragraph (h)(3) of this section; and

(vi) The proceeds of the contract are not payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person. (See paragraph (h)(7) of this section for special rules that apply in determining if this requirement is satisfied.)

(2) *Group affiliation requirement*—(i) *In general.* The group affiliation requirement of section 848(e)(2)(A) and this paragraph (h)(2) is satisfied only if all of the individuals eligible for coverage under the contract constitute a group described in paragraphs (h)(2) (ii) through (viii) of this section.

(ii) *Employee group.* An employee group consists of all of the employees (including statutory employees within the meaning of section 3121(d)(3) and individuals who are treated as employed by a single employer under section 414 (b), (c), or (m)), or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of an employer. For this purpose, the term ''employee'' includes—

(A) A retired or former employee;

(B) The sole proprietor, if the employer is a sole proprietorship;

(C) A partner of the partnership, if the employer is a partnership;

(D) A director of the corporation, if the employer is a corporation; and

(E) An elected or appointed official of the public body, if the employer is a public body.

(iii) *Debtor group.* A debtor group consists of all of the debtors, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a creditor. For this purpose, the term ''debtor'' includes a borrower of money or purchaser or lessee of goods, services, or property for which payment is arranged through a credit transaction.

(iv) *Labor union group.* A labor union group consists of all of the members, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a labor union or similar employee organization.

(v) *Association group.* An association group consists of all of the members, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of an association that, at the time the master contract is issued—

(A) Is organized and maintained for purposes other than obtaining insurance;

(B) Has been in active existence for at least two years (including, in the case of a merged or successor association, the years of active existence of any predecessor association); and

(C) Has at least 100 members.

(vi) *Credit union group.* A credit union group consists of all of the members or borrowers, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a credit union.

(vii) *Multiple group.* A multiple group consists of two or more groups from any single category described in paragraphs (h)(2) (ii) through (vi) of this section. A multiple group may not include two or more groups from different categories described in paragraph (h)(2) (ii) through (vi) of this section.

(viii) *Certain discretionary groups.* Provided that the contract otherwise satisfies the requirements of paragraph (h)(1) of this section, a contract issued to one of the following discretionary groups is treated as satisfying the group affiliation requirement of this paragraph (h)(2)—

(A) A contract issued to a group consisting of students of one or more universities or other educational institutions;

(B) A contract issued to a group consisting of members or former members of the U.S. Armed Forces;

(C) A contract issued to a group of individuas for the payment of future funeral expenses; and

(D) A contract issued to any other discretionary group as specified by the Commissioner in subsequent guidance published in the Internal Revenue Bulletin. (See § 601.601(d)(2)(ii)(*b*) of this chapter.)

(ix) *Employees treated as members.* In determining whether the group affiliation requirement of paragraph (h)(2) of this section is satisfied, the employees of a labor union, credit union, or association may be treated as members of a labor union group, a credit union group, or an association group, respectively.

(x) *Class or classes of a group determined without regard to individual health characteristics*—(A) *In general.* A class or classes of a group described in paragraphs (h)(2) (ii) through (viii) of this section may be determined using any reasonable characteristics (for example, amount of insurance, location, or occupation) other than individual health characteristics. The employees of a single employer covered under a policy issued to a multi-employer trust are considered a class of a group described in paragraph (h)(2)(ii) of this section.

(B) *Limitation of coverage based on certain work and age requirements permissible.* A limitation of coverage under a group contract to persons who are actively at work or of a pre-retirement age (for example, age 65 or younger) is not treated as based on individual health characteristics.

(3) *Premiums determined on a group basis*—(i) *In general.* Premiums for a contract are determined on a group basis for purposes of section 848(e)(2)(B) and this paragraph (h) only if the premium charged by the insurance company for each member of the group (or any class thereof) is determined on the basis of the same rates for the corresponding amount of coverage (for example, per $1,000 of insurance) or on the basis of rates which differ only because of the gender, smoking habits, or age of the member.

(ii) *Exception for substandard premium rates for certain high risk insureds.* Any difference in premium rates is disregarded for purposes of this paragraph (h)(3) if the difference is charged for an individual who was accepted for coverage at a substandard rate prior to January 1, 1993.

(iii) *Flexible premium contracts.* In the case of a group universal life insurance contract, the identical premium requirement is satisfied if the premium rates used by the insurance company in determining the periodic mortality charges applied to the policy account value of any member insured by the contract differ from those of other members (within the same class) only because of the gender, smoking habits, or age of the member.

(iv) *Determination of actual age.* For purposes of this paragraph (h)(3), determinations of actual age may be made using any reasonable method, provided that this method is applied consistently for all members of the group.

(4) *Underwriting practices used by company.* [Reserved]

(5) *Disqualification of group*—(i) *In general.* Except as otherwise provided in this paragraph (h)(5), if the requirements of paragraphs (h)(1), (2), and (3) of this section are not satisfied with respect to one or more members of the group, or of a class within a group (within the meaning of paragraph (h)(2)(x) of this section), the premiums for the entire group (or class) are treated as individual life insurance premiums.

(ii) *Exception for de minimis failures.* If the requirements of paragraphs (h) (1), (2), or (3) of this section are not satisfied with respect to one or more members of the group (or class), but the sum of the premiums charged by the insurance company for those individuals is no more than 5 percent of the aggregate premiums for the group (or class), only the premiums charged for those individuals are treated as premiums for an individual life insurance contract.

(6) *Supplemental life insurance coverage.* For purposes of determining whether the requirement in paragraph (h)(3)(i) of this section is satisfied, any supplemental life insurance coverage (including optional coverage for members of the group, their spouses, or their dependent children) is (or is treated as) a separate contract. In determining whether the group affiliation requirement of paragraph (h)(2) of this section is satisfied for the supplemental coverage, a member's spouse and dependent children are treated as members of the group if they are eligible for coverage.

(7) *Special rules relating to the payment of proceeds.* The following rules apply for purposes of section 848(e)(2) and paragraph (h)(1)(vi) of this section.

(i) *Contracts issued to a welfare benefit fund.* If a contract issued to a welfare benefit fund (as defined in section 419) provides for payment of proceeds to the welfare benefit fund, the proceeds of the contract are not considered payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person, provided the proceeds are paid as benefits to the employee or the employee's beneficiary.

(ii) *Credit life insurance contracts.* If a credit life insurance contract provides for payment of proceeds to the insured's creditor, the proceeds of the contract are not treated as payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person, provided the proceeds are applied against an outstanding indebtedness of the insured.

(iii) *''Organization or association'' limited to the sponsor of the contract or the group policyholder.* The term ''organization or association'' means the organization or association that is either the sponsor of the contract or the group policyholder.

(i) *General deductions.* The term ''general deductions'' is defined in section 848(c)(2). An insurance company determines its general deductions for the taxable year without regard to amounts capitalized or amortized under section 848(a). The amount of a company's general deductions is also determined without regard to the rules of § 1.848–2(f), which apply only for purposes of determining net consideration for reinsurance agreements.

[T.D. 8456, 57 FR 61819, Dec. 29, 1992; 58 FR 9245, Feb. 19, 1993]

§ 1.848–2 Determination of net premiums.

(a) *Net premiums*—(1) *In general.* An insurance company must use the accrual method of accounting (as prescribed by section 811(a)(1)) to determine the net premiums with respect to each category of specified insurance contracts. With respect to any category of contracts, net premiums means—

(i) The gross amount of premiums and other consideration (see paragraph (b) of this section); reduced by

(ii) The sum of—

(A) The return premiums (see paragraph (e) of this section); and

(B) The net negative consideration for a reinsurance agreement (other than an agreement described in paragraph (h)(2) of this section). See paragraphs (f) and (g) of this section for rules relating to the determination of net negative consideration.

(2) *Separate determination of net premiums for certain reinsurance agreements.* Net premiums with respect to reinsurance agreements for which an election under paragraph (h)(3) of this section has been made (certain reinsurance agreements with parties not subject to United States taxation) are treated separately and are subject to the rules of paragraph (h) of this section.

(b) *Gross amount of premiums and other consideration*—(1) *General rule.* The term ''gross amount of premiums and other consideration'' means the sum of—

(i) All premiums and other consideration (other than amounts on reinsurance agreements); and

(ii) The net positive consideration for any reinsurance agreement (other than an agreement for which an election under paragraph (h)(3) of this section has been made).

(2) *Items included.* The gross amount of premiums and other consideration includes—

(i) Advance premiums;

(ii) Amounts in a premium deposit fund or similar account, to the extent provided in paragraph (b)(3) of this section;

(iii) Fees;

(iv) Assessments;

(v) Amounts that the insurance company charges itself representing premiums with respect to benefits for its employees (including full-time life insurance salesmen treated as employees under section 7701(a)(20)); and

(vi) The value of a new contract issued in an exchange described in paragraph (c)(2) or (c)(3) of this section.

(3) *Treatment of premium deposits*—(i) *In general.* An amount in a premium deposit fund or similar account is taken into account in determining the gross amount of premiums and other consideration at the earlier of the time that the amount is applied to, or irrevocably committed to, the payment of a premium on a specified insurance contract. If an amount is irrevocably committed to the payment of a premium on a specified insurance contract, then neither that amount nor any earnings allocable to that amount are included in the gross amount of premiums and other consideration when applied to the payment of a premium on the same contract.

(ii) *Amounts irrevocably committed to the payment of premiums.* Except as provided in paragraph (b)(3)(iii) of this section, an amount in a premium deposit fund or similar account is irrevocably committed to the payment of premiums on a contract only if neither the amount nor any earnings allocable to that amount may be—

(A) Returned to the policyholder or any other person (other than on surrender of the contract); or

(B) Used by the policyholder to fund another contract.

(iii) *Retired lives reserves.* Premiums received by an insurance company under a retired lives reserve arrangement are treated as irrevocably committed to the payment of premiums on a specified insurance contract.

(4) *Deferred and uncollected premiums.* The gross amount of premiums and other consideration does not include deferred and uncollected premiums.

(c) *Policy exchanges*—(1) *General rule.* Except as otherwise provided in this paragraph (c), an exchange of insurance contracts (including a change in the terms of a specified insurance contract) does not result in any amount being included in the gross amount of premiums and other consideration.

(2) *External exchanges.* If a contract is exchanged for a specified insurance contract issued by another insurance

company, the company that issues the new contract must include the value of the new contract in the gross amount of premiums and other consideration.

(3) *Internal exchanges resulting in fundamentally different contracts*—(i) *In general.* If a contract is exchanged for a specified insurance contract issued by the same insurance company that issued the original contract, the company must include the value of the new contract in the gross amount of premiums and other consideration if the new contract—

(A) Relates to a different category of specified insurance contract than the original contract;

(B) Does not cover the same insured as the original contract; or

(C) Changes the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided in the original contract.

(ii) *Certain modifications treated as not changing the mortality, morbidity, interest, or expense guarantees.* For purposes of paragraph (c)(3)(i)(C) of this section, the following items are not treated as changing the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided in the contract—

(A) A change in a temporary guarantee with respect to the amounts to be credited as interest to the policyholder's account, or charged as mortality, morbidity, or expense charges, if the new guarantee applies for a period of ten years or less;

(B) The determination of benefits on annuitization using rates which are more favorable to the policyholder than the permanently guaranteed rates; and

(C) Other items as specified by the Commissioner in subsequent guidance published in the Internal Revenue Bulletin.

(iii) *Exception for contracts restructured by a court supervised rehabilitation or similar proceeding.* No amount is included in the gross amount of premiums and other consideration with respect to any change made to the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits of contracts of an insurance company that is the subject of a rehabilitation, conservatorship, insolvency, or similar state proceeding. This treatment applies only if the change—

(A) Occurs as part of the rehabilitation, conservatorship, insolvency, or similar state proceeding; and

(B) Is approved by the state court, the state insurance department, or other state official with authority to act in the rehabilitation, conservatorship, insolvency, or similar state proceeding.

(4) *Value of the contract*—(i) *In general.* For purposes of paragraph (c)(2) or (c)(3) of this section, the value of the new contract is established through the most recent sale by the company of a comparable contract. If the value of the new contract is not readily ascertainable, the value may be approximated by using the interpolated terminal reserve of the original contract as of the date of the exchange.

(ii) *Special rule for group term life insurance contracts.* In the case of any exchange involving a group term life insurance contract without cash value, the value of the new contract is deemed to be zero.

(iii) *Special rule for certain policy enhancement and update programs*—(A) *In general.* If the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits of a specified insurance contract are changed pursuant to a policy enhancement or update program, the value of the contract included in the gross amount of premiums and other consideration equals 30 percent of the value determined under paragraph (c)(4) of this section.

(B) *Policy enhancement or update program defined.* For purposes of paragraph (c)(4)(iii)(A) of this section, a policy enhancement or update program means any offer or commitment by the insurance company to all of the policyholders holding a particular policy form to change the interest, mortality, morbidity, or expense guarantees used to determine the contract's nonforfeiture benefits.

(5) *Example.* The principles of this paragraph (c) are illustrated by the following example.

Example. (i) An individual (A) owns a life insurance policy issued by a life insurance company (L1). On January 1, 1993, A purchases additional term insurance for $250, which is added as a rider to A's life insurance policy. The purchase of the additional term insurance does not change the interest mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided by A's life insurance policy.

(ii) A's purchase of the term insurance rider is not considered to result in a fundamentally different contract under paragraph (c)(3) of this section because the addition of the rider did not change the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture values of A's original life insurance policy. Therefore, L1 includes only the $250 received from A in the gross amount of premiums and other consideration.

(d) *Amounts excluded from the gross amount of premiums and other consideration*—(1) *In general.* The following items are not included in the gross amount of premiums and other consideration—

(i) Items treated by section 808(e) as policyholder dividends that are paid to the policyholder and immediately returned to the insurance company as a premium on the same contract that generated the dividends, including—

(A) A policyholder dividend applied to pay a premium under the contract that generated the dividend;

(B) Excess interest accumulated within the contract;

(C) A policyholder dividend applied for additional coverage (for example, a paid-up addition, extension of the period for which insurance protection is provided, or reduction of the period for which premiums are paid) on the contract that generated the dividend;

(D) A policyholder dividend applied to reduce premiums otherwise payable on the contract that generated the dividend;

(E) An experience-rated refund applied to pay a premium on the group contract that generated the refund; and

(F) An experience-rated refund applied to a premium stabilization reserve held with respect to the group contract that generated the refund;

(ii) Premiums waived as a result of the disability of an insured or the disability or death of a premium payor;

(iii) Premiums considered to be paid on a contract as the result of a partial surrender or withdrawal from the contract, or as a result of the surrender or withdrawal of a paid-up addition previously issued with respect to the same contract; and

(iv) Amounts treated as premiums upon the selection by a policyholder or by a beneficiary of a settlement option provided in a life insurance contract.

(2) *Amounts received or accrued from a guaranty association.* Amounts received or accrued from a guaranty association relating to an insurance company that is subject to an insolvency, delinquency, conservatorship, rehabilitation, or similar proceeding are not included in the gross amount of premiums and other consideration.

(3) *Exclusion not to apply to dividend accumulations.* For purposes of section 848(d)(3) and paragraph (d)(1) of this section, amounts applied from a dividend accumulation account to pay premiums on a specified insurance contract are not amounts treated as paid to, and immediately returned by, the policyholder.

(e) *Return premiums.* For purposes of section 848(d)(1)(B) and this section, return premiums do not include policyholder dividends (as defined in section 808), claims or benefits payments, or amounts returned to another insurance company under a reinsurance agreement. For the treatment of amounts returned to another insurance company under a reinsurance agreement, see paragraph (f) of this section.

(f) *Net consideration for a reinsurance agreement*—(1) *In general.* For purposes of section 848, the ceding company and the reinsurer must treat amounts arising from the reinsurance of a specified insurance contract consistently in determining their net premiums. See paragraph (g) of this section for restrictions on the amount of the net negative consideration for any reinsurance agreement that may be taken into account. See paragraph (h) of this section for special rules applicable to reinsurance agreements with parties not subject to United States taxation.

(2) *Net consideration determined by a ceding company*—(i) *In general.* The net consideration determined by a ceding company for a reinsurance agreement equals—

(A) The gross amount incurred by the reinsurer with respect to the reinsurance agreement, including any ceding commissions, annual allowances, reimbursements of claims and benefits, modified coinsurance reserve adjustments under paragraph (f)(5) of this section, experience-rated adjustments, and termination payments; less

(B) The gross amount of premiums and other consideration incurred by the ceding company with respect to the reinsurance agreement.

(ii) *Net negative and net positive consideration.* If the net consideration is less than zero, the ceding company has net negative consideration for the reinsurance agreement. If the net consideration is greater than zero, the ceding company has net positive consideration for the reinsurance agreement.

(3) *Net consideration determined by the reinsurer*—(i) *In general.* The net consideration determined by a reinsurer for a reinsurance agreement equals—

(A) The amount described in paragraph (f)(2)(i)(B) of this section; less

(B) The amount described in paragraph (f)(2)(i)(A) of this section.

(ii) *Net negative and net positive consideration.* If the net consideration is less than zero, the reinsurer has net negative consideration for the reinsurance agreement. If the net consideration is greater than zero, the reinsurer has net positive consideration for the reinsurance agreement.

(4) *Timing consistency required.* For purposes of determining the net consideration of a party for a reinsurance agreement, an income or expense item is taken into account for the first taxable year for which the item is required to be taken into account by either party. Thus, the ceding company and the reinsurer must take the item into account for the same taxable year (or for the same period if the parties have different taxable years).

(5) *Modified coinsurance and funds-withheld reinsurance agreements*—(i) *In general.* In the case of a modified coinsurance or funds-withheld reinsurance agreement, the net consideration for the agreement includes the amount of any payments or reserve adjustments, as well as any related loan transactions between the ceding company and the reinsurer. The amount of any investment income transferred between the parties as the result of a reserve adjustment or loan transaction is treated as an item of consideration under the reinsurance agreement.

(ii) *Special rule for certain funds-withheld reinsurance agreements.* In the case of a funds-withheld reinsurance agreement that is entered into after November 14, 1991, but before the first day of the first taxable year beginning after December 31, 1991, and is terminated before January 1, 1995, the parties' net consideration in the year of termination must include the amount of the original reserve for any reinsured specified insurance contract that, in applying the provisions of subchapter L, was treated as premiums and other consideration incurred for reinsurance for the taxable year in which the agreement became effective.

(6) *Treatment of retrocessions.* For purposes of this paragraph (f), a retrocession agreement is treated as a separate reinsurance agreement. The party that is relieved of liability under a retrocession agreement is treated as the ceding company.

(7) *Mixed reinsurance agreement.* If a reinsurance agreement includes more than one category of specified insurance contracts (or specified insurance contracts and contracts that are not specified insurance contracts), the portion of the agreement relating to each category of reinsured specified insurance contracts is treated as a separate agreement. The portion of the agreement relating to reinsured contracts that are not specified insurance contracts is similarly treated as a separate agreement.

(8) *Treatment of policyholder loans.* For purposes of determining the net consideration under a reinsurance agreement, the transfer of a policyholder loan receivable is treated as an item of consideration under the agreement. The interest credited with respect to a policyholder loan receivable is treated as investment income earned directly by the party holding the receivable. The amounts taken into account as claims and benefit reimbursements under the agreement must be determined without reduction for the policyholder loan.

(9) *Examples.* The principles of this paragraph (f) are illustrated by the following examples.

Example 1. On July 1, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement whereby L2 becomes solely liable to the policyholders under the contracts reinsured. L1 and L2 are calendar year taxpayers. Under the assumption reinsurance agreement, L1 agrees to pay L2 $100,000 for assuming the life insurance contracts, and L2 agrees to pay L1 a $17,000 ceding commission. Under paragraph (f)(2) of this section, L1 has net negative consideration of ($83,000) ($17,000 ceding commission incurred by L2—$100,000 incurred by L1 for reinsurance). Under paragraph (f)(3) of this section, L2 has net positive consideration of $83,000. Under paragraph (b)(1)(ii) of this section, L2 includes the net positive consideration in its gross amount of premiums and other consideration.

Example 2. (i) On July 1, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement whereby L1 remains liable to the policyholders under the reinsured contracts. L1 and L2 are calendar year taxpayers. Under the indemnity reinsurance agreement, L1 agrees to pay L2 $100,000 for reinsuring the life insurance contracts, and L2 agrees to pay L1 a $17,000 ceding commission. L1 agrees to pay L2 an amount equal to the future premiums on the reinsured contracts. L2 agrees to indemnify L1 for claims and benefits and administrative expenses incurred by L1 while the reinsurance agreement is in effect.

(ii) For the period beginning July 1, 1992, and ending December 31, 1992, the following income and expense items are determined with respect to the reinsured contracts:

Item	Income	Expense
Premiums	$25,000	....
Death benefits	....	$10,000
Surrender benefits	....	8,000
Premium taxes and other expenses	....	2,000
Total	....	20,000

(iii) Under paragraph (f)(2) of this section, L1's net negative consideration equals ($88,000), which is determined by subtracting the $125,000 ($100,000 + $25,000) incurred by L1 from the $37,000 incurred by L2 under the reinsurance agreement ($17,000 + $10,000 + $8,000 + $2,000). L2's net positive consideration is $88,000. Under paragraph (b)(1)(ii) of this section, L2 includes the $88,000 net positive consideration in its gross amount of premiums and other consideration.

Example 3. (i) Assume that the reinsurance agreement referred to in *Example 2* is terminated on December 31, 1993. During the period from January 1, 1993 through December 31, 1993, the following income and expense items are determined with respect to the reinsured contracts:

Item	Income	Expense
Premiums	$45,000	....
Death benefits	....	$18,000
Surrender benefits	....	6,000
Premium taxes and other expenses	....	8,000
Total	....	32,000

(ii) On the termination of the reinsurance agreement, L1 receives a payment of $70,000 from L2 as consideration for releasing L2 from liability with respect to the reinsured contracts.

(iii) L1's net positive consideration equals $57,000, which is the excess of the $102,000 incurred by L2 for the year ($18,000 + $6,000 + $8,000 + $70,000) over the $45,000 incurred by L1. L2's net negative consideration is ($57,000). L1 includes the net positive consideration in its gross amount of premiums and other consideration.

Example 4. (i) On January 1, 1993, an insurance company (L1) enters into a modified coinsurance agreement with another insurance company (L2), covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with an initial reinsurance premium equal to L1's reserves on the reinsured contracts at the inception of the agreement, any new premiums received with respect to the reinsured contracts, any decrease in L1's reserves on the reinsured contracts, and an amount of investment income determined by reference to L1's reserves on the reinsured contracts. L2 is charged for all claims and expenses incurred with respect to the reinsured contracts plus an amount reflecting any increase in L1's reserves. The agreement further provides that cash settlements between the parties are made at the inception and termination of the agreement, as well as at the end of each calendar year while the agreement is in effect. The cash settlement is determined by netting the sum of the amounts credited to L2 against the sum of the amounts charged to L2 with respect to the reinsured policies. L1's reserves on the reinsured policies at the inception of the reinsurance agreement are $375,000.

(ii) Under the cash settlement formula, L2 is credited with an initial reinsurance premium equal to L1's reserves on the reinsured policies ($375,000), but is charged an amount reflecting L1's policy reserve requirements ($375,000).

(iii) For the period ending December 31, 1993, L2 is also credited and charged the following amounts with respect to the reinsured contracts.

Item	Income	Expense
Premiums	$100,000	....
Investment income	39,000	....
Death benefits	....	$65,000
Increase in reserves	....	75,000

(iv) Under paragraph (f)(5) of this section, L2's net negative consideration for the 1993 taxable year equals ($1,000) which is determined by subtracting the sum of the amounts charged to L2 ($375,000 + $65,000 + $75,000 = $515,000) from the sum of the amounts credited to L2 ($375,000 + $100,000 + $39,000 = $514,000). L1's net positive consideration for calendar year 1993 equals $1,000. Under paragraph (b)(1)(ii) of this section, L1 includes the $1,000 net positive consideration in its gross amount of premiums and other consideration.

Example 5. (i) On January 1, 1993, an insurance company (L1) enters into a coinsurance agreement with another insurance company (L2) covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with an initial reinsurance premium equal to L1's reserves on the effective date of the agreement, any new premiums received on the reinsured contracts, but must indemnify L1 of all claims and expenses incurred with respect to the contracts. As part of the agreement, L2 makes a loan to L1 equal to the amount of the reserves on the reinsured contracts. L1's reserves on the reinsured contracts on the effective date of the agreement are $375,000. Thus, on the inception date of the reinsurance agreement, L1 transfers to L2 its note for $375,000 as consideration for reinsurance.

(ii) The reinsurance agreement between L1 and L2 is a funds-withheld reinsurance agreement. Under paragraph (f)(5) of this section, the amount of any loan transaction is taken into account in determining the parties' net consideration. At the inception of the reinsurance agreement, L2 is credited with a reinsurance premium equal to L1's reserves on the reinsured contracts ($375,000). L2's $375,000 loan to L1 is treated as an amount returned to L1 under the agreement.

(iii) For the period ending December 31, 1993, L2 is credited and charged the following amounts with respect to the reinsured contracts and the loan transaction with L1.

Item	Income	Expense
Premiums	$100,000	....
Accrued interest	39,000	....
Death benefits	....	$65,000
Increase in loan to L1	....	75,000

(iv) Under paragraph (f)(5) of this section, L2's net negative consideration for the 1993 taxable year equals ($1,000), which is determined by subtracting the sum of amounts incurred by L2 with respect to death benefits and the loan transaction ($375,000 + $65,000 + $75,000 = $515,000) from the sum of the amounts credited to L2 as reinsurance premiums and interest on the loan transaction ($375,000 + $100,000 + 39,000 = $514,000). L1's net positive consideration for calendar year 1993 equals $1,000. Under paragraph (b)(1)(ii) of this section, L1 includes the $1,000 net positive consideration in its gross amount of premiums and other consideration.

Example 6. (i) On December 31, 1993, an insurance company (L1) enters into a reinsurance agreement with another insurance company (L2) covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with L1's reserves on the reinsured contracts on the effective date of the agreement, plus any new premiums received on the reinsured contracts, but must indemnify L1 for all claims and expenses incurred with respect to the contracts. Under the agreement, L1 transfers cash of $325,000 to L2 plus rights to its policyholder loan receivables on the reinsured contracts ($50,000). L2 reports the reinsurance agreement by including the transferred policyholder loan receivables as an asset on its books.

(ii) For the period beginning January 1, 1994 and ending December 31, 1994, the following income and expense items are incurred with respect to the reinsured contracts.

Item	Income	Expense
Premiums	$100,000	....
Death benefits	....	$25,000
Surrender benefits	....	5,000
Premium taxes and other expenses	....	8,000
Total	....	38,000

(iii) These amounts are net of the outstanding policyholder loans held by L2 of $20,000 with respect to death benefits and $15,000 with respect to surrender benefits.

(iv) Under paragraph (f)(8) of this section, the transferred policyholder loan receivables are treated as an item of consideration under the reinsurance agreement. In determining the parties' net consideration for the agreement, the transferred policyholder loan receivables ($50,000) are treated as an item of consideration incurred by L1 under paragraph (f)(2)(i)(B) of this section. Therefore, for the 1993 taxable year, L1 has net negative consideration of ($375,000). L2 has net positive consideration of $375,000. Under paragraph (b)(1)(ii) of this section, L2 includes the $375,000 net positive consideration in its gross amount of premiums and other consideration.

(v) For the 1994 taxable year, L2 has net positive consideration for the reinsurance agreement of $62,000 before adjustment for the transferred policyholder loans. Under paragraph (f)(8) of this section, the amounts taken into account as claim and benefit payments must be adjusted by the amount of any transferred policyholder loan receivables which are netted against the reinsurer's claim and benefit reimbursements. Therefore, L2 takes into account $45,000 ($25,000+$20,000=$45,000) as reimbursements for death benefits, and $20,000 ($5,000+$15,000=$20,000) as reimbursements for surrender benefits. After adjustment for these items, L2 has net positive consideration of $27,000, which is determined by subtracting the sum of the amounts charged to L2 ($45,000+$20,000+$8,000=$73,000) from the sum of the amounts credited to L2 ($100,000). L1 has net negative consideration of ($27,000) under the agreement. Under paragraph (b)(1)(ii) of this section, L2 includes the $27,000 net positive consideration in its gross amount of premiums and other consideration. The amount of any interest earned on the policyholder loan receivables after their transfer to L2 is treated as investment income earned directly by L2, and is not taken into account as an item of consideration under the agreement.

(g) *Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements*—(1) *In general.* Paragraph (g)(3) of this section provides for a reduction in the amount of net negative consideration that a party to a reinsurance agreement (other than a reinsurance agreement described in paragraph (h)(2) of this section) may take into account in determining net premiums under paragraph (a)(2)(ii) of this section if the party with net positive consideration has a capitalization shortfall (as defined in paragraph (g)(4) of this section). Unless the party with net negative consideration demonstrates that the party with net positive consideration does not have a capitalization shortfall or demonstrates the amount of the other party's capitalization shortfall which is allocable to the reinsurance agreement, the net negative consideration that may be taken into account under paragraph (a)(2)(ii) of this section is zero. However, the reduction of paragraph (g)(3) of this section does not apply to a reinsurance agreement if the parties make a joint election under paragraph (g)(8) of this section. Under the election, the party with net positive consideration capitalizes specified policy acquisition expenses with respect to the agreement without regard to the general deductions limitation of section 848(c)(1).

(2) *Application to reinsurance agreements subject to the interim rules.* In applying this paragraph (g) to a reinsurance agreement that is subject to the interim rules of § 1.848–3, the term ''premiums and other consideration incurred for reinsurance under section 848(d)(1)(B)'' is substituted for ''net negative consideration,'' and the term ''gross amount of premiums and other consideration under section 848(d)(1)(A)'' is substituted for ''net positive consideration.'' If an insurance company has ''premiums and other consideration incurred for reinsurance under section 848(d)(1)(B)'' and a ''gross amount of premiums and other consideration under section 848(d)(1)(A)'' for the same agreement, the net of these amounts is taken into account for purposes of this paragraph (g).

(3) *Amount of reduction.* The reduction required by this paragraph (g)(3) equals the amount obtained by dividing—

(i) The portion of the capitalization shortfall (as defined in paragraph (g)(4) of this section) allocated to the reinsurance agreement under paragraph (g)(7) of this section; by

(ii) The applicable percentage set forth in section 848(c)(1) for the category of specified insurance contracts reinsured by the agreement.

(4) *Capitalization shortfall.* A ''capitalization shortfall'' equals the excess of—

(i) The sum of the required capitalization amounts (as defined in paragraph (g)(5) of this section) for all reinsurance agreements (other than reinsurance agreements for which an election has been made under paragraph (h)(3) of this section); over

(ii) The general deductions allocated to those reinsurance agreements, as determined under paragraph (g)(6) of this section.

(5) *Required capitalization amount*—(i) *In general.* The ''required capitalization amount'' for a reinsurance agreement (other than a reinsurance agreement for which an election has been made under paragraph (h)(3) of this section)

equals the amount (either positive or negative) obtained by multiplying—

(A) The net positive or negative consideration for an agreement not described in paragraph (h)(2) of this section, and the net positive consideration for an agreement described in paragraph (h)(2) of this section, but for which an election under paragraph (h)(3) of this section has not been made; by

(B) The applicable percentage set forth in section 848(c)(1) for that category of specified insurance contracts.

(ii) *Special rule with respect to net negative consideration.* Solely for purposes of computing a party's required capitalization amount under this paragraph (g)(5)—

(A) If either party to the reinsurance agreement is the direct issuer of the reinsured contracts, the party computing its required capitalization amount takes into account the full amount of any net negative consideration without regard to any potential reduction under paragraph (g)(3) of this section; and

(B) If neither party to the reinsurance agreement is the direct issuer of the reinsured contracts, any net negative consideration is deemed to equal zero in computing a party's required capitalization amount except to the extent that the party with the net negative consideration establishes that the other party to that reinsurance agreement capitalizes the appropriate amount.

(6) *General deductions allocable to reinsurance agreements.* An insurance company's general deductions allocable to its reinsurance agreements equals the excess, if any, of—

(i) The company's general deductions (excluding additional amounts treated as general deductions under paragraph (g)(8) of this section); over

(ii) The amount determined under section 848(c)(1) on specified insurance contracts that the insurance company has issued directly (determined without regard to any reinsurance agreements).

(7) *Allocation of capitalization shortfall among reinsurance agreements.* The capitalization shortfall is allocated to each reinsurance agreement for which the required capitalization amount (as determined in paragraph (g)(5) of this section) is a positive amount. The portion of the capitalization shortfall allocable to each agreement equals the amount which bears the same ratio to the capitalization shortfall as the required capitalization amount for the reinsurance agreement bears to the sum of the positive required capitalization amounts.

(8) *Election to determine specified policy acquisition expenses for an agreement without regard to general deductions limitation*—(i) *In general.* The reduction specified by paragraph (g)(3) of this section does not apply if the parties to a reinsurance agreement make an election under this paragraph (g)(8). The election requires the party with net positive consideration to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation of section 848(c)(1). That party must reduce its deductions under section 805 or section 832(c) by the amount, if any, of the party's capitalization shortfall allocable to the reinsurance agreement. The additional capitalized amounts are treated as specified policy acquisition expenses attributable to premiums and other consideration on the reinsurance agreement, and are deductible in accordance with section 848(a)(2).

(ii) *Manner of making election.* To make an election under paragraph (g)(8) of this section, the ceding company and the reinsurer must include an election statement in the reinsurance agreement, either as part of the original terms of the agreement or by an addendum to the agreement. The parties must each attach a schedule to their federal income tax returns which identifies the reinsurance agreement for which the joint election under this paragraph (g)(8) has been made. The schedule must be attached to each of the parties' federal income tax returns filed for the later of—

(A) The first taxable year ending after the election becomes effective; or

(B) The first taxable year ending on or after December 29, 1992.

(iii) *Election statement.* The election statement in the reinsurance agreement must—

(A) Provide that the party with net positive consideration for the reinsurance agreement for each taxable year will capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation of section 848(a)(1);

(B) Set forth the agreement of the parties to exchange information pertaining to the amount of net consideration under the reinsurance agreement each year to ensure consistency;

(C) Specify the first taxable year for which the election is effective; and

(D) Be signed by both parties.

(iv) *Effect of election.* An election under this paragraph (g)(8) is effective for the first taxable year specified in the election statement and for all subsequent taxable years for which the reinsurance agreement remains in effect. The election may not be revoked without the consent of the Commissioner.

(9) *Example.* The principles of this paragraph (g) are illustrated by the following examples.

Example 1. (i) On December 31, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement in which L2 becomes solely liable to the policyholders on the reinsured contracts. L1 transfers $105,000 to L2 as consideration for the reinsurance of the contracts.

(ii) L1 and L2 do not make an election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. L2 has no other insurance business, and its general deductions for the taxable year are $3,500.

(iii) Under paragraph (f)(2) of this section, L1's net negative consideration is ($105,000). Under paragraph (f)(3) of this section, L2's net positive consideration is $105,000. Pursuant to paragraph (b)(1)(ii) of this section, L2 includes the net positive consideration in its gross amount of premiums and other consideration.

(iv) The required capitalization amount under paragraph (g)(5) of this section for the reinsurance agreement is $8,085 ($105,000×.077). L2's general deductions, all of which are allocable to the reinsurance agreement with L1, are $3,500. The $4,585 difference between the required capitalization amount ($8,085) and the general deductions allocable to the reinsurance agreement ($3,500) represents L2's capitalization shortfall under paragraph (g)(4) of this section.

(v) Since L2 has a capitalization shortfall allocable to the agreement, the rules of paragraph (g)(1) of this section apply for purposes of determining the amount by which L1 may reduce its net premiums. Under paragraph (g)(3) of this section, L1 must reduce the amount of net negative consideration that it takes into account under paragraph (a)(2)(ii) of this section by $59,545 ($4,585/.077). Thus, of the $105,000 net negative consideration under the reinsurance agreement, L1 may take into account only $45,455 as a reduction of its net premiums.

Example 2. The facts are the same as *Example 1,* except that L1 and L2 make the election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. Pursuant to this election, L2 must capitalize as specified policy acquisition expenses an amount equal to $8,085 ($105,000×.077). L1 may reduce its net premiums by the $105,000 of net negative consideration.

Example 3. (i) A life insurance company (L1) is both a direct issuer and a reinsurer of life insurance and annuity contracts. For 1993, L1's net premiums under section 848 (d)(1) for directly issued individual life insurance and annuity contracts are as follows:

Category	Net premiums
Life insurance contracts	$17,000,000
Annuity contracts	8,000,000

(ii) L1's general deductions for 1993 are $1,500,000.

(iii) For 1993, L1 is a reinsurer under four separate indemnity reinsurance agreements with unrelated insurance companies (L2, L3, L4, and L5). The agreements with L2, L3, and L4 cover life insurance contracts issued by those companies. The agreement with L5 covers annuity contracts issued by L5, The parties to the reinsurance agreements have not made the election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to these agreements without regard to the general deductions limitation.

(iv) L1's net consideration for 1993 with respect to its reinsurance agreements is as follows:

Agreement	Net consideration
L2	$1,200,000
L3	(350,000)
L4	300,000
L5	600,000

(v) To determine whether a reduction under paragraph (g)(3) of this section applies with respect to these reinsurance agreements, L1 must determine the required capitalization amounts for its reinsurance agreements and the amount of its general deductions allocable to these agreements.

(vi) Pursuant to paragraph (g)(5) of this section, the required capitalization amount for each reinsurance agreement is determined as follows:

L2 .... \$1,200,000×.077=\$92,400
L3 .... (\$350,000)×.077=(\$26,950)
L4 .... \$300,000×.077=\$23,100
L5 .... \$600,000×.0175=\$10,500

(vii) Thus, the sum of L1's required capitalization amounts on its reinsurance agreements equals \$99,050.

(viii) Pursuant to paragraph (g)(6) of this section, L1 determines its general deductions allocable to its reinsurance agreements. The amount determined under section 848(c)(1) on its directly issued contracts is:

REQUIRED CAPITALIZATION AMOUNT

Category:		
Annuity contracts	\$8,000,000×.0175 =	\$140,000
Life insurance contracts	\$17,000,000×.077 =	1,309,000
		\$1,449,000

(ix) L1's general deductions allocable to its reinsurance agreements are \$51,000 (\$1,500,000 − \$1,449,000).

(x) Pursuant to paragraph (g)(4) of this section, L1's capitalization shortfall equals \$48,050, reflecting the excess of L1's required capitalization amounts for its reinsurance agreements (\$99,050) over the general deductions allocable to its reinsurance agreements (\$51,000).

(xi) Pursuant to paragraph (g)(7) of this section, the capitalization shortfall of \$48,050 must be allocated between each of L1's reinsurance agreements with net positive consideration in proportion to their respective required capitalization amounts. The allocation of the shortfall between L1's reinsurance agreements is determined as follows:

L2=\$35,237 (\$48,050×92,400/126,000)
L4=\$8,809 (\$48,050×23,100/126,000)
L5=\$4,004 (\$48,050×10,500/126,000)

(xii) Accordingly, the reduction under paragraph (g)(3) of this section that applies to the amount of net negative consideration that may be taken into account by L2, L4, and L5 under paragraph (a)(1)(ii)(B) of this section is determined as follows:

L2=\$457,623 (\$35,237/.077)
L4=\$114,403 (\$8,809/.077)
L5=\$228,800 (\$4,004/.0175)

Example 4. The facts are the same as *Example 3*, except that L1 and L4 make a joint election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. Pursuant to this election, L1 must reduce its deductions under section 805 by an amount equal to the capitalization shortfall allocable to the reinsurance agreement with L4 (\$8,809). L1 treats the additional capitalized amounts as specified policy acquisition expenses allocable to premiums and other consideration under the agreement. L4 may reduce its net premiums by the \$300,000 net negative consideration. The election by L1 and L4 does not change the amount of the capitalization shortfall allocable under paragraph (g)(7) of this section to the reinsurance agreements with L2 and L5. Thus, the reduction required by paragraph (g)(3) of this section with respect to the amount of the net negative consideration that L2 and L5 may recognize under paragraph (a)(2)(ii) of this section is \$457,623 and \$228,800, respectively.

(h) *Treatment of reinsurance agreements with parties not subject to U.S. taxation*—(1) *In general.* Unless an election under paragraph (h)(3) of this section is made, an insurance company may not reduce its net premiums by the net negative consideration for the taxable year (or, with respect to a reinsurance agreement that is subject to the interim rules of §1.848–3, by the premiums and other consideration incurred for reinsurance) under a reinsurance agreement to which this paragraph (h) applies.

(2) *Agreements to which this paragraph (h) applies*—(i) *In general.* This paragraph (h) applies to a reinsurance agreement if, with respect to the premiums and other consideration under the agreement, one party to that agreement is subject to United States taxation and the other party is not.

(ii) *Parties subject to U.S. taxation*—(A) *In general.* A party is subject to United States taxation for this purpose if the party is subject to United States taxation either directly under the provisions of subchapter L of chapter 1 of the Internal Revenue Code (subchapter L), or indirectly under the provisions of subpart F of part III of subchapter N of chapter 1 of the Internal Revenue Code (subpart F).

(B) *Effect of a closing agreement.* If a reinsurer agrees in a closing agreement with the Internal Revenue Service to be subject to tax under rules equivalent to the provisions of subchapter L on its premiums and other consideration from reinsurance agreements with parties subject to United States taxation, the reinsurer is treated as an insurance company subject to tax under subchapter L.

(3) *Election to separately determine the amounts required to be capitalized for reinsurance agreements with parties not subject to U.S. taxation*—(i) *In general.* This paragraph (h)(3) authorizes an insurance company to make an election to separately determine the amounts required to be capitalized for the taxable year with respect to reinsurance agreements with parties that are not subject to United States taxation. If this election is made, an insurance company separately determines a net foreign capitalization amount for the taxable year for all reinsurance agreements to which this paragraph (h) applies.

(ii) *Manner of making the election.* An insurance company makes the election authorized by this paragraph (h)(3) by attaching an election statement to the federal income tax return (including an amended return) for the taxable year for which the election becomes effective. The election applies to that taxable year and all subsequent taxable years unless permission to revoke the election is obtained from the Commissioner.

(4) *Amount taken into account for purposes of determining specified policy acquisition expenses.* If for a taxable year an insurance company has a net positive foreign capitalization amount (as defined in paragraph (h)(5)(i) of this section), any portion of that amount remaining after the reduction described in paragraph (h)(7) of this section is treated as additional specified policy acquisition expenses for the taxable year (determined without regard to amounts taken into account under this paragraph (h)). A net positive capitalization amount is treated as an amount otherwise required to be capitalized for the taxable year for purposes of the reduction under section 848(f)(1)(A).

(5) *Net foreign capitalization amount*—(i) *In general.* An insurance company's net foreign capitalization amount equals the sum of the foreign capitalization amounts (netting positive and negative amounts) determined under paragraph (h)(5)(ii) of this section for each category of specified insurance contracts reinsured by agreements described in paragraph (h)(2) of this section. If the amount is less than zero, the company has a net negative foreign capitalization amount. If the amount is greater than zero, the company has a net positive foreign capitalization amount.

(ii) *Foreign capitalization amounts by category.* The foreign capitalization amount for a category of specified insurance contracts is determined by—

(A) Combining the net positive consideration and the net negative consideration for the taxable year (or, with respect to a reinsurance agreement that is subject to the interim rules of §1.848–3, by combining the gross amount of premiums and other consideration and the premiums and other consideration incurred for reinsurance) for all agreements described in paragraph (h)(2) of this section which reinsure specified insurance contracts in that category; and

(B) Multiplying the result (either positive or negative) by the percentage for that category specified in section 848(c)(1).

(6) *Treatment of net negative foreign capitalization amount*—(i) *Applied as a reduction to previously capitalized amounts.* If for a taxable year an insurance company has a net negative foreign capitalization amount, the negative amount reduces (but not below zero) the unamortized balances of the amounts previously capitalized (beginning with the amount capitalized for the most recent taxable year) to the extent attributable to prior years' net positive foreign capitalization amounts. The amount by which previously capitalized amounts is reduced is allowed as a deduction for the taxable year.

(ii) *Carryover of remaining net negative foreign capitalization amount.* The net negative foreign capitalization amount, if any, remaining after the reduction described in paragraph (h)(6)(i) of this section is carried over to reduce a future net positive capitalization amount. The remaining net negative foreign capitalization amount may only offset a net positive foreign capitalization amount in a future year, and may not be used to reduce the amounts otherwise required to be capitalized under section 848(a) for the taxable year, or to reduce the unamortized balances of specified policy acquisition expenses from preceding taxable years, with respect to directly written business or reinsurance agreements other than agreements for which the election under paragraph (h)(3) of this section has been made.

(7) *Reduction of net positive foreign capitalization amount by carryover amounts allowed.* If for a taxable year an insurance company has a net positive foreign capitalization amount, that amount is reduced (but not below zero) by any carryover of net negative foreign capitalization amounts from preceding taxable years. Any remaining net positive foreign capitalization amount is taken into account as provided in paragraph (h)(4) of this section.

(8) *Examples.* The principles of this paragraph (h) are illustrated by the following examples.

Example 1. (i) On January 1, 1993, a life insurance company (L1) enters into a reinsurance agreement with a foreign corporation (X) covering a block of annuity contracts issued to residents of the United States. X is not subject to taxation either directly under subchapter L or indirectly under subpart F on the premiums for the reinsurance agreement with L1. L1 makes the election under paragraph (h)(3) of this section to separately determine the amounts required to be capitalized for the taxable year with respect to parties not subject to United States taxation.

(ii) For the taxable year ended December 31, 1993, L1 has net negative consideration of ($25,000) under its reinsurance agreement with X. L1 has no other reinsurance agreements with parties not subject to United States taxation.

(iii) Under paragraph (h)(5) of this section, L1's net negative foreign capitalization amount for the 1993 taxable year equals ($437.50), which is determined by multiplying L1's net negative consideration on the agreement with X ($25,000) by the percentage in section 848(c)(1) for the reinsured specified insurance contracts (1.75%). Under paragraph (h)(6)(ii) of this section, L1 carries over the net negative foreign capitalization amount of $437.50) to future taxable years. The net negative foreign capitalization amount may not be used to reduce the amounts which L1 is required to capitalize on directly written business or reinsurance agreements other than those agreements described in paragraph (h)(2) of this section.

Example 2. (i) The facts are the same as *Example 1* except that L1 terminates its reinsurance agreement with X and receives $35,000 on December 31, 1994. For the 1994 taxable year, L1 has net positive consideration of $35,000 under its agreement with X. L1 has no other reinsurance agreements with parties not subject to United States taxation.

(ii) Under paragraph (h)(5) of this section, L1's net positive net foreign capitalization amount for the 1984 taxable year equals $612.50, which is determined by multiplying the net positive consideration on the agreement with X ($35,000) by the percentage in section 848(c)(1) for the reinsured specified insurance contracts (1.75%). Under paragraph (h)(4) of this section, L1 reduces the net positive foreign capitalization amount for the taxable year by the net negative foreign capitalization amount carried over from preceding taxable years ($437.50). After this reduction, L1 includes $175 ($612.50–$437.50) as specified policy acquisition expenses for the 1994 taxable year.

(i) *Carryover of excess negative capitalization amount*—(1) *In general.* This paragraph (i) authorizes a carryover of an excess negative capitalization amount (as defined in paragraph (i)(2) of this section) to reduce amounts otherwise required to be capitalized under section 848. Paragraph (i)(4) provides special rules for the treatment of excess negative capitalization amounts of insolvent insurance companies.

(2) *Excess negative capitalization amount.* The excess negative capitalization amount with respect to a category of specified insurance contracts for a taxable year is equal to the excess of—

(A) The negative capitalization amount with respect to that category; over

(B) The amount that can be utilized under section 848(f)(1).

(3) *Treatment of excess negative capitalization amount.* The excess negative capitalization amount for a taxable year reduces the amounts that are otherwise required to be capitalized by an insurance company under section 848(c)(1) for future years.

(4) *Special rule for the treatment of an excess negative capitalization amount of an insolvent company*—(i) *When applicable.* This paragraph (i)(4) applies only for the taxable year in which an insolvent insurance company has an excess negative capitalization amount and has net negative consideration under a reinsurance agreement. See paragraph (i)(4)(v) of this section for the definition of ''insolvent.''

(ii) *Election to forego carryover of excess negative capitalization amount.* At the joint election of the insolvent insurance company and the other party to the reinsurance agreement—

(A) The insolvent insurance company reduces the excess negative capitalization amount which would otherwise be carried over under paragraph (i)(1) of this section by the amount determined under paragraph (i)(4)(iii) of this section; and

(B) The other party reduces the amount of its specified policy acquisition expenses for the taxable year by the amount determined under paragraph (i)(4)(iii) of this section.

(iii) *Amount of reduction to the excess negative capitalization amount and specified policy acquisition expenses.* To determine the reduction to the carryover of an insolvent insurance company's excess negative capitalization amount and the specified policy acquisition expenses of the other party with respect to a reinsurance agreement—

(A) Multiply the net negative consideration for each reinsurance agreement of the insolvent insurer for which there is net negative consideration for the taxable year by the appropriate percentage specified in section 848(c)(1) for the category of specified insurance contracts reinsured by the agreement;

(B) Sum the results for each agreement;

(C) Calculate the ratio between the results in paragraphs (i)(4)(iii) (A) and (B) of this section for each agreement; and

(D) Multiply that result by the increase in the excess negative capitalization amount of the insolvent insurer for the taxable year.

(iv) *Manner of making election.* To make an election under paragraph (i)(4) of this section, each party to the reinsurance agreement must attach an election statement to its federal income tax return (including an amended return) for the taxable year for which the election is effective. The election statement must identify the reinsurance agreement for which the joint election under this paragraph (i)(4) has been made, state the amount of the reduction to the insolvent insurance company's excess negative capitalization amount that is attributable to the agreement, and be signed by both parties. An election under this paragraph (i)(4) is effective for the taxable year specified in the election statement, and may not be revoked without the consent of the Commissioner.

(v) *Presumptions relating to the insolvency of an insurance company undergoing a court supervised rehabilitation or similar state proceeding.* For purposes of this paragraph (i)(4), an insurance company which is undergoing a rehabilitation, conservatorship, or similar state proceeding shall be presumed to be insolvent if the state proceeding results in—

(A) An order of the state court finding that the fair market value of the insurance company's assets is less than its liabilities;

(B) The use of funds, guarantees, or reinsurance from a guaranty association;

(C) A reduction of the policyholders' available account balances; or

(D) A substantial limitation on access to funds (for example, a partial or total moratorium on policyholder withdrawals or surrenders that applies for a period of 5 years).

(vi) *Example.* The principles of this paragraph (i)(4) are illustrated by the following example.

Example. (i) An insurance company (L1) is the subject of a rehabilitation proceeding under the supervision of a state court. The state court has made a finding that the fair market value of L1's assets is less than its liabilities. On December 31, 1993, L1 transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an assumption reinsurance agreement whereby L2 becomes solely liable to the policyholders under the contracts reinsured. Under the agreement, L1 agrees to pay L2 $2,000,000 for assuming the life insurance contracts. This negative net consideration causes L1 to incur an excess negative capitalization amount of $138,600 for the 1993 taxable year. L1 has no other reinsurance agreements for the taxable year.

(ii) As part of the reinsurance agreement, L1 and L2 agree to make an election under paragraph (i)(4) of this section. Under the election, L1 agrees to forgo the carryover of the $138,600 excess negative capitalization amount for future taxable years. L2 must include the $2,000,000 net positive consideration for the reinsurance agreement in its gross amount of premiums and other consideration. L2 reduces its specified policy acquisition expenses for the 1993 taxable year by $138,600.

(j) *Ceding commissions with respect to reinsurance of contracts other than specified insurance contracts.* A ceding commission incurred with respect to the reinsurance of an insurance contract that is not a specified insurance contract is not subject to the provisions of section 848(g).

(k) *Effective dates*—(1) *In general.* Unless otherwise specified in this paragraph, the rules of this section are effective for the taxable years of an insurance company beginning after November 14, 1991.

(2) *Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements.* Section 1.848–2(g) (which provides for an adjustment to ensure consistency) is effective for—

(i) All amounts arising under any reinsurance agreement entered into after November 14, 1991; and

(ii) All amounts arising under any reinsurance agreement for taxable years beginning after December 31, 1991, without regard to the date on which the reinsurance agreement was entered into.

(3) *Net consideration rules.* Section 1.848–2(f) (which provides rules for determining the net consideration for a reinsurance agreement) applies to—

(i) Amounts arising in taxable years beginning after December 31, 1991, under a reinsurance agreement entered into after November 14, 1991; and

(ii) Amounts arising in taxable years beginning after December 31, 1994, under a reinsurance agreement entered into before November 15, 1991.

(4) *Determination of the date on which a reinsurance agreement is entered into.* A reinsurance agreement is considered entered into at the earlier of—

(i) The date of the reinsurance agreement; or

(ii) The date of a binding written agreement to enter into a reinsurance transaction if the written agreement evidences the parties' agreement on substantially all material items relating to the reinsurance transaction.

(5) *Special rule for certain reinsurance agreements with parties not subject to U.S. taxation.* The election and special rules in paragraph (h) of this section relating to the determination of amounts required to be capitalized on reinsurance agreements with parties not subject to United States taxation apply to taxable years ending on or after September 30, 1990.

(6) *Carryover of excess negative capitalization amount.* The provisions of paragraph (i) of this section, including the special rule for the treatment of excess negative capitalization amounts of insolvent insurance companies, are affected with respect to amounts arising in taxable years ending on or after September 30, 1990.

[T.D. 8456, 57 FR 61821, Dec. 29, 1992; 58 FR 7987, Feb. 11, 1993; 59 FR 947, Jan. 7, 1994]

§ 1.848–3 Interim rules for certain reinsurance agreements.

(a) *Scope and effective dates.* The rules of this section apply in determining net premiums for a reinsurance agreement with respect to—

(1) Amounts arising in taxable years beginning before January 1, 1992, under a reinsurance agreement entered into after November 14, 1991; and

(2) Amounts arising in taxable years beginning before January 1, 1995, under a reinsurance agreement entered into before November 15, 1991.

(b) *Interim rules.* In determining a company's gross amount of premiums and other consideration under section 848(d)(1)(A) and premiums and other consideration incurred for reinsurance under section 848(d)(1)(B), the general rules of subchapter L of the Internal Revenue Code apply with the adjustments and special rules set forth in paragraph (c) of this section. Except as provided in paragraph (c)(5) of this section (which applies to modified coinsurance transactions), the gross amount of premiums and other consideration is determined without any reduction for ceding commissions, annual allowances, reimbursements of claims and benefits, or other amounts incurred by a reinsurer with respect to reinsured contracts.

(c) *Adjustment and special rules.* This paragraph sets forth certain adjustments and special rules that apply for reinsurance agreements in determining the gross amount of premiums and other consideration under section 848(d)(1)(A) and premiums and other considerations incurred for reinsurance under section 848(d)(1)(B).

(1) *Assumption reinsurance.* The ceding company must treat the gross amount of consideration incurred with respect to an assumption reinsurance agreement as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The reinsurance must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). For rules relating to the determination and treatment of ceding commissions, see paragraph (c)(3) of this section.

(2) *Reimbursable dividends.* The reinsurer must treat the amount of policyholder dividends reimbursable to the ceding company (other than under a modified coinsurance agreement covered by paragraph (c)(5) of this section) as a return premium under section 848(d)(1)(B). The ceding company must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). The amount of any experience-related refund due the ceding company is treated as a policyholder dividend reimbursable to the ceding company.

(3) *Ceding commissions*—(i) *In general.* The reinsurer must treat ceding commissions as a general deduction. The ceding company must treat ceding commissions as non-premium related income under section 803(a)(3). The ceding company may not reduce its general deductions by the amount of the ceding commission.

(ii) *Amount of ceding commission.* For purposes of this section, the amount of a ceding commission equals the excess, if any, of—

(A) The increase in the reinsurer's tax reserves resulting from the reinsurance agreement (computed in accordance with section 807(d)); over

(B) The gross consideration incurred by the ceding company for the reinsurance agreement, less any amount incurred by the reinsurer as part of the reinsurance agreement.

(4) *Termination payments.* The reinsurer must treat the gross amount of premiums and other consideration payable as a termination payment to the ceding company (including the tax reserves on the reinsured contracts) as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The ceding company must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). This paragraph does not apply to modified coinsurance agreements.

(5) *Modified coinsurance agreements.* In the case of a modified coinsurance agreement, the parties must determine their net premiums on a net consideration basis as described in § 1.848–2(f)(5).

(D) *Examples.* The principles of this section are illustrated by the following examples.

Example 1. On July 1, 1991, an insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policy holder under the contracts reinsured. The tax reserves on the reinsured contracts are $100,000. Under the assumption reinsurance agreement, L1 pays L2 $83,000 for assuming the life insurance contracts. Under paragraph (c)(3) of this section, since the increase in L2's tax reserves ($100,000) exceeds the net consideration transferred by L1 ($83,000), the reinsurance agreement provides for a ceding commission. The ceding commission equals $17,000 ($100,000-$83,000). Under paragraph (c)(3) of this section, L1 reduces its gross amount of premiums and other consideration for the 1991 taxable year under section 848(d)(1)(B) by the $100,000 premium incurred for reinsurance, and L2 includes the $100,000 premium for reinsurance in its gross amount of premiums and other consideration under section 848(d)(1)(A). L1 treats the $17,000 ceding commission as non-premium related income and section 803 (a)(3).

Example 2. On July 1, 1991, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policyholder under the contracts reinsured. The tax reserves on the reinsured contracts are $100,000. Under the assumption reinsurance agreement, L1 pays L2 $100,000 for assuming the contracts, and L2 pays L1 a $17,000 ceding commission. Under paragraph (c)(1) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by $100,000. L2 includes $100,000 in its gross amount of premiums and other consideration under section 848(d)(1)(A). Under paragraph (c)(3) of this section, since the increase in L2's tax reserves ($100,000) exceeds the net consideration transferred by L1, the reinsurance agreement provides for a ceding commission. The ceding commission equals $17,000 ($100,000 increase in L2's tax reserves less $83,000 net consideration transferred by L1). L1 treats the $17,000 ceding commission as non-premium related income under section 803(a)(3).

Example 3. On July 1, 1991, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policyholder under the contracts reinsured. Under the assumption reinsurance agreement, L1 transfers assets of $105,000 to L2. The tax reserves on the reinsured contracts are $100,000. Under paragraph (c)(1) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by $105,000, and L2 increases its gross amount of premiums and other consideration under section 848(d)(1)(A) by $105,000. Since the net consideration transferred by L1 exceeds the increase in L2's tax reserves, there is no ceding commission under paragraph (c)(3) of this section.

Example 4. (i) On June 30, 1991, a life insurance company (L1) reinsures 40% of certain individual life insurance contracts to be issued after that date with an unrelated insurance company (L2) under an agreement whereby L1 remains directly liable to the policyholders with respect to the contracts reinsured. The agreement provides that L2 is credited with 40% of any premiums received with respect to the reinsured contracts, but must indemnify L1 for 40% of any claims, expenses, and policyholder dividends. During the period from July 1 through December 31, 1991, L1 has the following income and expense items with respect to the reinsured policies:

Item	Income	Expense
Premiums	$8,000	....
Benefits paid	....	$1,000
Commissions	....	6,000
Policyholder dividends	....	500
Total	....	7,500

(ii) Under paragraphs (b) and (c)(2) of this section, L1 includes $8,200 in its gross amount of premiums and other consideration under section 848(d)(1)(A) ($8,000 gross premiums on the reinsured contracts plus $200 of policyholder dividends reimbursed by L2 ($500×40%). L1 reduces its gross amount of premiums and other consideration by $3,200 (40%×$8,000) as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The benefits and commissions incurred by L1 with respect to the reinsured contracts do not reduce L1's gross amount of premiums and other consideration under section 848(d)(1)(B). L2 includes $3,200 in its gross amount of premiums and other consideration (40%×$8,000) and is treated as having paid return premiums of $200 (the amount of reimbursable dividends paid to L1). L2 is also treated as having incurred the following expenses with respect to the reinsured contracts: $400 as benefits paid (40%×$1,000) and $2,400 as commissions expense (40%×$6,000). Under paragraph (b) of this section, these expenses do not reduce L2's gross amount of premiums and other consideration under section 848(d)(1)(A).

Example 5. On December 31, 1991, an insurance company (L1) terminates a reinsurance agreement with an unrelated insurance company (L2). The termination applies to a reinsurance agreement under which L1 had ceded 40% of its liability on a block of individual life insurance contracts to L2. Upon termination of the reinsurance agreement, L2 makes a final payment of $116,000 to L1 for assuming full liability under the contracts. The tax reserves attributable to L2's portion of the reinsured contracts are $120,000. Under paragraph (c)(4) of this section, L2 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by $120,000. L1 includes $120,000 in its gross amount of premiums and other consideration under section 848(d)(1)(A).

Example 6. (i) On June 30, 1991, an insurance company (L1) reinsures 40% of its existing life insurance contracts with an unrelated life insurance company (L2) under a modified coinsurance agreement. For the period July 1, 1991 through December 31, 1991, L1 reports the following income and expense items with respect to L2's 40% share of the reinsured contracts:

Item	Income	Expense
Premiums	$10,000	
Benefits paid	....	$4,000
Policyholder dividends	....	500
Reserve adjustment	....	1,500
Total	....	6,000

(ii) Pursuant to paragraph (c)(5) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by the $4,000 net consideration for the modified coinsurance agreement ($10,000–$6,000). L2 includes the $4,000 net consideration in its gross amount of premiums and other consideration under section 848(d)(1)(A).

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