against all of X's assets if X defaults on the financing.

(ii) Under paragraph (b)(2)(i) of this section, the personal property is disregarded as incidental property used in the activity of holding real property. Under paragraph (b)(4) of this section, the personal liability of X for repayment of the financing is disregarded and, provided the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property.

Example 2. Bifurcation of a financing. The facts are the same as in *Example 1*, except that A, a member of X, is personally liable for repayment of $100 of the financing. If the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, then under paragraph (b)(3) of this section, the portion of the financing for which A is not personally liable for repayment ($400) will be treated as qualified nonrecourse financing secured by real property.

Example 3. Personal liability; tiered partnerships. (i) UTP1 and UTP2, both limited liability companies classified as partnerships, are the only general partners in Y, a limited partnership. Y borrows $500 with respect to the activity of holding real property. The financing is a general obligation of Y. UTP1 and UTP2, therefore, are personally liable to repay the financing. Under section 752, UTP1's share of the financing is $300, and UTP2's share is $200. No person other than Y, UTP1, and UTP2 is personally liable to repay the financing. Y, UTP1, and UTP2 each hold only real property.

(ii) Under paragraph (b)(4) of this section, the personal liability of Y, UTP1, and UTP2 to repay the financing is disregarded and, provided the requirements of paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, UTP1's $300 share of the financing and UTP2's $200 share of the financing will be treated as qualified nonrecourse financing secured by real property.

Example 4. Personal liability; tiered partnerships. The facts are the same as in *Example 3*, except that Y's general partners are UTP1 and B, an individual. Because B, an individual, is also personally liable to repay the $500 financing, the entire financing fails to satisfy the requirement in paragraph (b)(1)(iii) of this section. Accordingly, UTP1's $300 share of the financing will not be treated as qualified nonrecourse financing secured by real property.

Example 5. Personal liability; tiered partnerships. The facts are the same as in *Example 3*, except that Y is a limited liability company and UTP1 and UTP2 are not personally liable for the debt. However, UTP1 and UTP2 each pledge property as security for the loan that is other than real property used in the activity of holding real property and other than property that is incidental to the activity of holding real property. The fair market value of the property pledged by UTP1 and UTP2 is greater than 10 percent of the sum of the aggregate gross fair market value of the property held by Y and the aggregate gross fair market value of the property pledged by UTP1 and UTP2. Accordingly, the financing fails to satisfy the requirement in paragraph (b)(1)(iii) of this section by virtue of its failure to satisfy paragraph (b)(4)(iii) of this section. Therefore, the financing is not qualified nonrecourse financing secured by real property.

Example 6. Personal liability; Disregarded entity. (i) X is a single member limited liability company that is disregarded as an entity separate from its owner for federal tax purposes under §301.7701–3 of this chapter. X owns certain real property and property that is incidental to the activity of holding the real property. X does not own any other property. For federal tax purposes, A, the sole member of X, is considered to own all of the property held by X and is engaged in the activity of holding real property through X. X borrows $500 and uses the proceeds to purchase additional real property that is used in the activity of holding real property. X is personally liable to repay the financing, but A is not personally liable for repayment of the financing under local law. The lender may proceed against all of X's assets if X defaults on the financing.

(ii) X is disregarded so that the assets and liabilities of X are treated as the assets and liabilities of A. However, A is not personally liable for the $500 liability. Provided that the requirements contained in paragraphs (b)(1)(i), (ii), and (iv) of this section are satisfied, the financing will be treated as qualified nonrecourse financing secured by real property with respect to A.

(c) *Effective date.* This section is effective for any financing incurred on or after August 4, 1998. Taxpayers, however, may apply this section retroactively for financing incurred before August 4, 1998.

[T.D. 8777, 63 FR 41421, Aug. 4, 1998]

§ 1.466–1 Method of accounting for the redemption cost of qualified discount coupons.

(a) *Introduction.* Section 466 permits taxpayers who elect to use the method of accounting description in section 466 to deduct the redemption cost (as defined in paragraph (b) of this section) of qualified discount coupons (as defined in paragraph (c) of this section) outstanding at the end of the taxable year and redeemed during the redemption period (within the meaning of paragraph (d)(2) of this section) in addition to the redemption cost of qualified discount coupons redeemed during the taxable year which were not deducted for a prior taxable year. For the taxable year in which the taxpayer first uses this method of accounting, the taxpayer is not allowed to deduct the redemption costs of qualified discount coupons redeemed during the taxable year that would have been deductible for the prior taxable year had the taxpayer used this method of accounting for such prior year. (See paragraph (e) of this section for rules describing how this amount should be taken into account.) A taxpayer must use the accrual method of accounting for any trade or business for which an election is made under section 466. Furthermore, the taxpayer must make an election in accordance with the rules in section 466(d) and §1.466–3 for that trade or business. The method of accounting in section 466 is applicable only to the taxpayer's redemption of qualified discount coupons. Section 466 does not apply to trading stamps or premium coupons, which are subject to the method of accounting in §1.451–4, or to discount coupons that are not qualified discount coupons.

(b) *Redemption costs*—(1) *Costs deductible under section 466.* The deduction allowed by section 466 applies only to the redemption cost of qualified discount coupons. The term ''redemption cost'' means an amount equal to:

(i) The lesser of:

(A) The amount of the discount stated on the coupon, or

(B) The cost incurred by the taxpayer for paying the discount; plus

(ii) The amount payable to the retailer (or other person redeeming the coupon from the person receiving the price discount) for services in redeeming the coupon.

The amount payable to the retailer or other person for services in redeeming the coupon is allowed only if the amount payable is stated on the coupon.

(2) *Costs not deductible under section 466.* The term ''redemption cost'' includes only the amounts stated in paragraph (b)(1) of this section. Amounts other than those mentioned in paragraph (b)(1) of this section cannot be deducted under the method of accounting described in section 466 even though such amounts are incurred in relation to the redemption of qualified discount coupons. Therefore, those amounts must be taken into account as if section 466 did not apply. Examples of such amounts are fees paid to the redemption center or clearinghouse and amounts payable to the retailer in excess of the amount stated on the coupon.

(c) *Qualified discount coupons*—(1) *General rule.* In order for a discount coupon (as defined in paragraph (c)(2)(i) of this section) to be considered a qualified discount coupon, all of the following requirements must be met:

(i) The coupon must have been issued by and must be redeemable by the taxpayer;

(ii) The coupon must allow a discount on the purchase price of merchandise or other tangible personal property;

(iii) The face amount of the coupon must not exceed five dollars;

(iv) The coupon, by its terms, may not be used with other coupons to bring about a price discount reimbursable by the issuer of more than five dollars with respect to any item; and

(v) There must exist a redemption chain (as defined in paragraph (c)(2)(ii) of this section) with respect to the coupon.

(2) *Definitions*—(i) *Discount coupon.* A discount coupon is a sales promotion device used to encourage the purchase of a specific product by allowing a purchaser of that product to receive a discount on its purchase price. The term ''discount coupon'' does not include trading stamps or premium coupons, which are subject to the method of accounting in §1.451–4. A discount coupon may or may not be issued as part of a prior purchase. A discount coupon normally entitles its holders to receive nothing more than a reduction in the sales price of one of the issuer's products. The discount may be stated in terms of a cash amount, a percentage or fraction of the purchase price, a ''two for the price of one'' deal, or any other similar provision. A discount coupon need not be printed on paper in the form usually associated with coupons; it may be a token or other object so long as it functions as a coupon.

(ii) *Redemption chain.* A redemption chain exists when the issuer redeems the coupon from some person other than the customer who used the coupon to receive the price discount. Thus, in order to be treated as a qualified discount coupon, the coupon must not be issued by the person that initially redeems the coupon from the customer. For purposes of determining whether a redemption chain exists, corporations that are members of the same controlled group of corporations (as defined in section 1563(a)) as the issuer of the coupon shall be treated as the issuer. Thus, if the issuer of the coupon and the retailer that initially redeems the coupon from the customer are members of the same controlled group of corporations, the coupon shall not be treated as a qualified discount coupon.

(d) *Deduction for coupons redeemed during the redemption period*—(1) *General rule.* Two special conditions must be met before the cost of redeeming qualified discount coupons during the redemption period can be deducted from the taxpayer's gross income for the taxable year preceding the redemption period. First, the qualified discount coupons must have been outstanding at the close of such taxable year. Second, the qualified discount coupons must have been received by the taxpayer before the close of the redemption period for that taxable year.

(2) *Redemption period.* The taxpayer can select any redemption period so long as the period does not extend longer than 6 months after the close of the taxapayer's taxable year. A change in the redemption period so selected shall be treated as a change in method of accounting.

(3) *Coupons received.* The deduction provided for in section 466(a)(1) is limited to the redemption costs associated with coupons that are actually received by the taxpayer within the redemption period. For purposes of this paragraph, if the issuer uses a redemption agent or clearinghouse to group, count, and verify coupons after they have been redeemed by a retailer, the coupons received by the redemption agent or clearinghouse will be considered to have been received by the issuer. Nothing in section 466, however, allows deductions to be made on the basis of estimated redemptions, whether such estimates are made by either the issuer or some other party.

(e) *Transitional adjustment*—(1) *In general.* An election to change from some other method of accounting for the redemption of discount coupons to the method of accounting described in section 466 is a change in method of accounting that requires a transitional adjustment. Unless the taxpayer can qualify for a waiver of the suspense account requirement as provided for in section 373(c) of the Revenue Act of 1978 (92 Stat. 2865), the taxpayer should compute the transitional adjustment described in section 481(a)(2) according to the rules contained in this section. This adjustment should be taken into account according to the special rules in subsections (e) and (f) of section 466.

(2) *Net increase in taxable income.* In the case of a transitional adjustment that would result in a net increase in taxable income under section 481(a)(2) for the year of change, that increase should be taken into income over a ten-year period consisting of the year of change and the immediately succeeding nine taxable years. For example, assume that A, a calendar year taxpayer, makes an election to use the method of accounting described in section 466 for the year 1980 and for subsequent years. Assume further that the amount of the transitional adjustment computed under section 481(a)(2) would result in a net increase in taxable income of $100 for 1980. Under these facts, A should increase taxable income for 1980 and each of the next nine taxable years by $10.

(3) *Suspense account*—(i) *In general.* In the case of a transitional adjustment that would result in a net decrease in taxable income under section 481(a)(2) for the year of change, in lieu of applying section 481, the taxpayer must establish a separate suspense account for each trade or business for which the taxpayer has made an election to use section 466. The computation of the initial opening balance in the suspense account is described in paragraph (e)(3)(ii)(A) of this section. An initial adjustment to gross income for the year of election is described in paragaph (e)(3)(ii)(B) of this section.

Annual adjustments to the suspense account are described in paragraph (e)(3)(iii)(A) of this section, and gross income adjustments are described in paragraph (e)(3)(iii)(B) of this section. Examples are provided in paragraph (e)(4) of this section. The effect of the suspense account is to defer some part of, or all of, the deduction of the transitional adjustment until the taxpayer no longer redeems discount coupons in connection with the trade or business to which the suspense account relates.

(ii) *Establishing a suspense account*—(A) *Initial opening balance.* To compute the initial opening balance of the suspense account for the first taxable year for which the election to use section 466 is effective, the taxpayer must determine the dollar amount of the deduction that would have been allowed for qualified discount coupon redemption costs during the redemption period for each of the three immediately preceding taxable years had the election to use section 466 been in effect for those years. The initial opening balance of the suspense account is the largest such dollar amount reduced by the sum of the adjustments attributable to the change in method of accounting that increase income for the year of change.

(B) *Initial year adjustment.* If, in computing the initial opening balance, the largest dollar amount of deduction that would have been allowed in any of the three prior years exceeds the actual cost of redeeming qualified discount coupons received during the redemption period following the close of the year immediately preceding the year of election, the excess is included in income in the year of election. Section 481(b) does not apply to this increase in gross income.

(iii) *Annual adjustments*—(A) *Adjustment to the suspense account.* Adjustments are made to the suspense account each year to account for fluctuations in coupon redemptions. To compute the annual adjustment, the taxpayer must determine the amount to be deducted under section 466(a)(1) for the taxable year. If the amount is less than the opening balance in the suspense account for the taxable year, the balance in the suspense account is reduced by the difference. Conversely, if such amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference (but not to an amount in excess of the initial opening balance described in paragraph (e)(3)(ii) of this section). Therefore, the balance in the suspense account will never be greater than the initial opening balance in the suspense account determined in paragraph (e)(3)(ii) of this section. However, the balance in the suspense account after adjustments may be less than this initial opening balance in the suspense account.

(B) *Gross income adjustments.* Adjustments to the suspense account for years subsequent to the year of the election also produce adjustments in the taxpayer's gross income. Adjustments which reduce the balance in the suspense account reduce gross income for the year in which the adjustment to the suspense account is made. Adjustments which increase the balance in the suspense account increase gross income for the year in which the adjustment to the suspense account is made.

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

Example 1. Assume that the issuer of qualified discount coupons makes a timely election under section 466 for its taxable year ending December 31, 1979, and does not select a coupon redemption period shorter than the statutory period of 6 months. Assume further that the taxpayer's qualified discount coupon redemption costs in the first 6 months of 1977, 1978, and 1979 were $7, $13, and $8 respectively, and that the accounting change adjustments that increase income for 1979 are $10. Since the accounting change adjustment that increases income for 1979, ($10), is greater than the taxpayer's discount coupon redemptions during the first 6 months of 1979 ($8), the net section 481(a)(2) adjustment for the year of change results in a positive adjustment. Because of this, a suspense account is not required. The taxpayer should instead follow the rules in section 466(f) and in paragraph (e)(2) of this section in order to take this positive transitional adjustment into account.

Example 2. Assume the same facts as in Example 1, except that the sum of the accounting change adjustments that increase income for 1979 is equal to $2. Under these facts the initial opening balance in the suspense account on January 1, 1979 would be $11 (that is, the largest dollar amount of qualified coupon redemption costs in the pertinent years ($13), reduced by the sum of the accounting change adjustments that increase income in the year of change ($2)). Since the coupon redemption costs taken into account in determining the initial opening balance ($13 in 1979) exceed the actual redemption costs in the first 6 months of the taxable year for which the election is first effective ($8 in 1979), the excess of $5 is added to gross income for the year of election (1979).

Example 3. Assume, in addition to the facts of Example 2, that coupon redemption costs during the redemption period for the 1979 taxable year are $7. Since the qualifying redemption costs ($7) during the redemption period for the taxable year are less than the opening balance in the suspense account ($11) the taxpayer must reduce the suspense account balance by the difference ($4). The taxpayer is also allowed to take a deduction equal to the amount of this adjustment to the suspense account. Thus, the net amount deductible for the 1979 taxable year after taking into account the coupon redemptions during the redemption period, the amount deductible because of the decrease in the suspense account, and the initial year adjustment determined in Example 2 is $6 ($7+$4−$5).

Example 4. Assume, in addition to the facts of Example 3, that coupon redemption costs during the redemption period for the 1980 taxable year are $10. Since the qualifying redemption costs during the redemption period for the taxable year ($10) exceed the opening balance of the suspense account at the beginning of the taxable year ($7), the suspense account must be increased by the difference ($3). The taxpayer must also include $3 in gross income for the taxable year. Thus, the net amount deductible for the 1980 taxable year is $7 ($10−$3).

Example 5. Assume, in addition to the facts of Example 4, that coupon redemption costs during the redemption period for the 1981 taxable year are $12. Since the qualifying redemption costs for the 1961 taxable year ($12) exceed the opening balance of the suspense account at the beginning of the taxable year ($10), the suspense account must be increased by the difference ($2) but not above the initial opening balance ($11). Thus, the taxpayer will increase the balance by $1. The taxpayer must also include $1 in gross income for the taxable year. Thus, the net amount deductible for the 1981 taxable year is $11 ($12−$1).

(ii) The following table summarizes examples (2) through (5):

	Years ending Dec. 31—					
	1977	1978	1979	1980	1981	1982
Facts:						
Actual coupon redemption costs in first six months	$7	$13	$8	$7	$10	$12
Accounting change adjustments that increase income in year of change	....	....	2	....	....	....
Net adjustment decreasing income in year of change under sec. 481(a)(2)	....	....	6	....	....	....
Adjustment to suspense account:						
Opening balance	....	....	11	7	10	11
Addition to account	....	....	....	3	1	....
Reduction to account	....	....	(4)	....	....	....
Opening balance for next year	....	....	7	10	11	....
Amount deductible:						
Initial year adjustment	....	....	(5)	....	....	....
Amount of deductible as actual coupon redemptions during redemption period	....	....	7	10	12	....
Adjustment for increase in suspense account	....	....	....	(3)	(1)	....
Adjustment for decrease in suspense account	....	....	4	....	....	....
Net amount deductible for the year for coupons redeemed during the redemption period	....	....	6	7	11	....

(f) *Subchapter C transactions*—(1) *General rule*. If a transfer of substantially all the assets of a trade or business in which discount coupons are redeemed is made to an acquiring corporation, and if the acquiring corporation determines its bases in these assets, in whole or part, with reference to the basis of these assets in the hands of the transferor, then for the purposes of section 466(e) the principles of section 381 and §1.381(c)(4)–1 will apply. The application of this rule is not limited to the transactions described in section 381(a).

Thus, the rule also applies, for example, to transactions described in section 351.

(2) *Special rules*. If, in the case of a transaction described in paragraph (f)(1) of this section, an acquiring corporation acquires assets that were used in a trade or business that was not subject to a section 466 election from a transferor that is owned or controlled directly (or indirectly through a chain of corporations) by the same interests, and if the acquiring corporation uses the acquired assets in a trade or business for which the acquiring corporation later makes an election to use section 466, then the acquiring corporation must establish a suspense account by taking into account not only its own experience but also the transferor's experience when the transferor held the assets in its trade or business. Furthermore, the transferor is not allowed a deduction for qualified discount coupons redeemed after the date of the transfer attributable to discount coupons issued by the transferor before the date of the transfer. Such redemptions shall be considered to be made by the acquiring corporation.

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

Example. Corporation S, a calendar year taxpayer, is a wholly owned subsidiary of Corporation P, a calendar year taxpayer. On December 31, 1982, S acquires from P sustantially all of the assets used in a trade or business in which qualified disount coupons are redeemed. P had not made an election under section 466 with respect to the redemption costs of the qualified discount coupons issued in connection with that trade or business. S makes an election to use section 466 for its taxable year ending December 31, 1983, for the trade or business in which the acquired assets are used, and selects a redemption period of 6 months. Assume that P's qualified discount coupon redemption costs in the first 6 months of 1981 and 1982 were $120 and $140 respectively. Assume further that S's qualified discount coupon redemption costs in the first 6 months of 1983 were $130, and that there are no accounting change adjustments that increase income with respect to the election. S must establish a suspense account by taking into account the largest dollar amount of deductions that would have been allowed under section 466(a)(1) for the 3 immediately preceding taxable years of P, including both P's and S's experience with respect to costs actually incurred during the redemption periods relating to those years. Thus, the initial opening balance of S's suspense account is $140. S must also make an initial year adjustment of $10 ($140–$130), which S must include in income for S's taxable year ending December 31, 1983. P may not take a deduction for the qualified coupon redemptions made after December 31, 1982, that are attributable to coupons issued by P before December 31, 1982. Thus, none of the $130 qualified discount coupon redemption costs incurred by S during the first six months of 1983 may be deducted by P.

[T.D. 8022, 50 FR 18474, May 1, 1985, as amended at 50 FR 21046, May 22, 1985]

§ 1.466–2 Special protective election for certain taxpayers.

(a) *General rule*. Section 373(c) of the Revenue Act of 1978 (92 Stat. 2865) allows certain taxpayers, who in prior years have accounted for discount coupons under a method of accounting reasonably similar to the method described in § 1.451–4, to elect to treat that method of accounting as a proper one for those prior years. There are several differences between this protective election and the section 466(d) election. First, the protective election applies only to a single continuous period of taxable years the last year of which ends before January 1, 1979. Second, an otherwise qualifying protective election may apply to coupons which are discount coupons but which would not be treated as qualified discount coupons under Code section 466. Third, certain expenses such as the cost of redemption center service fees, and amounts that are payable to the retailer (or other person redeeming the coupons from the person receiving the price discount) for services in redeeming the coupons but that are not stated on the coupon, can be subtracted from gross receipts for prior years covered by a protective election (if treated as deductible under the accounting method for such years), even though such expenses would not be deductible under Code section 466.

(b) *Requirements*. In order to qualify for this special protective election, the following conditions must be met:

(1) For a continuous period of one or more prior taxable years, (the last year of which ends before Jan. 1, 1979), the taxpayer must have used a method of accounting for discount coupons that is