obligation was issued and repurchased and the amount (if any) by which the
selling price of the nonconvertible obligation was affected by reason of any
change in the issuing corporation’s credit quality or the credit quality of
the obligation during such period (determined on the basis of widely pub-
lished financial information or on the basis of other relevant facts and cir-
cumstances which reflect the relative credit quality of the corporation or the
comparable obligation).
(e)(2)(iii) through (f)(2) [Reserved] For further guidance, see §1.249–
1(e)(2)(iii) through (f)(2).
(3) Portion of repurchase premium at-
tributable to cost of borrowing. Par-
agraph (e)(2)(ii) of this section applies to
any repurchase of a convertible obliga-
tion occurring on or after July 6, 2011.
(g) [Reserved] For further guidance,
see §1.249–1(g).
(h) Expiration date. The applicability
of this section expires on or before July
1, 2014.
[T.D. 9533, 76 FR 39281, July 6, 2011]
ITEMS NOT DEDUCTIBLE
§ 1.261–1 General rule for disallowance
of deductions.
In computing taxable income, no de-
duction shall be allowed, except as oth-
erwise expressly provided in Chapter 1
of the Code, in respect of any of the
items specified in Part IX (section 262
and following), Subchapter B, Chapter
1 of the Code, and the regulations
thereunder.
§ 1.262–1 Personal, living, and family
expenses.
(a) In general. In computing taxable
income, no deduction shall be allowed
except as otherwise expressly provided
in chapter 1 of the Code, for personal,
living, and family expenses.
(b) Examples of personal, living, and
family expenses. Personal, living, and
family expenses are illustrated in the
following examples:
(1) Premiums paid for life insurance
by the insured are not deductible. See
also section 264 and the regulations
thereunder.
(2) The cost of insuring a dwelling
owned and occupied by the taxpayer as
a personal residence is not deductible.
(3) Expenses of maintaining a house-
hold, including amounts paid for rent,
water, utilities, domestic service, and the like, are not deductible. A taxpayer
who rents a property for residential
purposes, but incidentally conducts
business there (his place of business
being elsewhere) shall not deduct any
part of the rent. If, however, he uses
part of the house as his place of busi-
ness, such portion of the rent and other
similar expenses as is properly attrib-
buteable to such place of business is de-
ductible as a business expense.
(4) Losses sustained by the taxpayer
upon the sale or other disposition of
property held for personal, living, and
family purposes are not deductible. But
see section 165 and the regulations
thereunder for deduction of losses sus-
tained to such property by reason of
casualty, etc.
(5) Expenses incurred in traveling
away from home (which include trans-
portation expenses, meals, and lodging)
and any other transportation expenses
are not deductible unless they qualify
as expenses deductible under section
162, §1.162–2, and paragraph (d) of
§1.162–5 (relating to trade or business
deductions), section 170 and paragraph
(a)(2) of §1.170–2 or paragraph (g) of
§1.170A–1 (relating to charitable con-
tributions), section 212 and §1.212–1 (re-
ating to expenses for production of in-
come), section 213(e) and paragraph (e)
of §1.213–1 (relating to medical ex-
penses) or section 217(a) paragraph
(a) of §1.217–1 (relating to moving ex-
penses). The taxpayer’s costs of com-
muting to his place of business or em-
ployment are personal expenses and do
not qualify as deductible expenses. The
costs of the taxpayer’s lodging not in-
curred in traveling away from home
are personal expenses and are not de-
 ductible unless they qualify as deduct-
ible expenses under section 217. Except
as permitted under section 162, 212, or
217, the costs of the taxpayer’s meals
not incurred in traveling away from
home are personal expenses.
(6) Amounts paid as damages for
breach of promise to marry, and attor-
ney’s fees and other costs of suit to re-
cover such damages, are not deduct-
ible.
(7) Generally, attorney’s fees and
other costs paid in connection with a
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§ 1.263(a)–0  Table of contents.

This section lists captioned paragraphs contained in §§1.263(a)–1 through 1.263(a)–5.

§ 1.263(a)–1  Capital expenditures; in general.
(a) through (h) [Reserved] For further guidance, see the table of contents for §1.263(a)–1T(a) through (h) under §1.263(a)–0T.

§ 1.263(a)–2  Amounts paid to acquire or produce tangible property.
(a) through (i) [Reserved] For further guidance, see the table of contents for §1.263(a)–2T(a) through (i) under §1.263(a)–0T.

§ 1.263(a)–3  Amounts paid to improve tangible property.
(a) through (q) [Reserved] For further guidance, see the table of contents for §1.263(a)–3T(a) though (q) under §1.263(a)–0T.

§ 1.263(a)–4  Amounts paid to acquire or create intangibles.
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(e) Examples.
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(3) Special rules for certain costs.
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(5) Costs of asset sales.
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(7) Bankruptcy reorganization costs.
(8) Stock issuance costs of open-end regulated investment companies.
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(10) Registrar and transfer agent fees for the maintenance of capital stock records.
(11) Termination payments and amounts paid to facilitate mutually exclusive transactions.
(12) Simplifying conventions.
(13) Certain amounts treated as employee compensation.

(b) General rule.
(1) In general.
(2) Employee compensation.
(3) In general.
(4) In general.
(5) In general.
(6) Reasonable expectancy of renewal.
(7) Coordination with section 481.

(c) Special rules for certain costs.
(1) Borrowing costs.
(2) Costs of asset sales.
(3) Mandatory stock distributions.
(4) Bankruptcy reorganization costs.
(5) Stock issuance costs of open-end regulated investment companies.
(6) Integration costs.
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(d) Borrowing costs.
(1) In general.
(2) Costs of asset sales.
(3) Mandatory stock distributions.
(4) Bankruptcy reorganization costs.
(5) Stock issuance costs of open-end regulated investment companies.
(6) Integration costs.
(7) Registrar and transfer agent fees for the maintenance of capital stock records.
(8) Termination payments and amounts paid to facilitate mutually exclusive transactions.
(9) Simplifying conventions.
(10) Certain amounts treated as employee compensation.

(1) General rule.
(2) Scope of facilitate.
(3) In general.
(4) Ordering rules.
(5) Special rules for certain costs.
(6) Borrowing costs.
(7) Costs of asset sales.
(8) Mandatory stock distributions.
(9) Bankruptcy reorganization costs.
(10) Stock issuance costs of open-end regulated investment companies.
(11) Integration costs.
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(i) Acquirer.  
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§ 1.263(a)–1T Capital expenditures; in general.

(a) through (c) [Reserved] For further guidance, see § 1.263(a)&1T(a) through (c).

(d) through (h) [Reserved] For further guidance, see § 1.263(a)–1T(d) through (h).

[T.D. 9564, 76 FR 81101, Dec. 27, 2011]

§ 1.263(a)–1T Capital expenditures; in general (temporary)—

(a) General rule for capital expenditures. Except as provided in chapter 1 of the Internal Revenue Code, no deduction is allowed for—

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

(2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

(b) Coordination with section 263A. Section 263(a) generally requires taxpayers to capitalize an amount paid to acquire, produce, or improve real or personal tangible property. Section 263A generally prescribes the direct and indirect costs that must be capitalized to property produced by the taxpayer and property acquired for resale.

(c) Examples of capital expenditures. The following amounts paid are examples of capital expenditures:

(1) Capitalization of amounts to adapt property to a new or different use.

(2) Adapting buildings to new or different use.

(3) Examples.

(k) Optional regulatory accounting method.

(1) In general.

(2) Eligibility for regulatory accounting method.

(3) Description of regulatory accounting method.

(d) Examples.

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(m) Treatment of capital expenditures.

(n) Recovery of capitalized amounts.

(o) Accounting method changes.

(p) Effective/applicability date.

(q) Expiration date.

[T.D. 9564, 76 FR 81101, Dec. 27, 2011]
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(1) An amount paid to acquire or produce a unit of real or personal tangible property. See §1.263(a)–2T.

(2) An amount paid to improve a unit of real or personal tangible property. See §1.263(a)–3T.

(3) An amount paid to acquire or create intangibles. See §1.263(a)–4.

(4) An amount paid or incurred to facilitate an acquisition of a trade or business, a change in capital structure of a business entity, and certain other transactions. See §1.263(a)–5.

(5) An amount paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land.

(6) An amount assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. See section 118 and §1.118–1.

(7) An amount paid by a holding company to carry out a guaranty of dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary. This amount must be added to the cost of the stock in the subsidiary.

(d) Amounts paid to sell property—

(1) In general. Commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized. However, in the case of dealers in property, amounts paid to facilitate the sale of property are treated as ordinary and necessary business expenses. See §1.263(a)–5(g) for the treatment of amounts paid to facilitate the disposition of assets that constitute a trade or business.

(2) Treatment of capitalized amount. Amounts capitalized under paragraph (d)(1) of this section are treated as a reduction in the amount realized and generally are taken into account either in the taxable year in which the sale occurs or in the taxable year in which the sale is abandoned if a loss deduction is permissible. The capitalized amount is not added to the basis of the property and is not treated as an intangible under §1.263(a)–4.

(3) Examples. The following examples, which assume the sale is not an installment sale under section 453, illustrate the rules of this paragraph (d):

Example 1. Sales costs of real property. X owns a parcel of real estate. X sells the real estate and pays legal fees, recording fees, and sales commissions to facilitate the sale. X must capitalize the fees and commissions and, in the taxable year of the sale, offset the fees and commissions against the amount realized from the sale of the real estate.

Example 2. Sales costs of dealers. Assume the same facts as in Example 1, except that X is a dealer in real estate. The commissions and fees paid to facilitate the sale of the real estate are treated as ordinary and necessary business expenses under section 162.

Example 3. Sales costs of personal property used in a trade or business. X owns a truck for use in X's trade or business. X decides to sell the truck on November 15, Year 1. X pays for an appraisal to determine a reasonable asking price. On February 15, Year 2, X sells the truck to Y. X is required to capitalize in Year 1 the amount paid to appraise the truck and, in Year 2, is required to offset the amount paid against the amount realized from the sale of the truck.

Example 4. Costs of abandoned sale of personal property used in a trade or business. Assume the same facts as in Example 1, except that, instead of selling the truck on February 15, Year 2, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in Year 1 the amount paid to appraise the truck. However, X may treat the amount paid to appraise the truck as a loss under section 165 in Year 2 when the sale is abandoned.

Example 5. Sales costs of personal property not used in a trade or business. Assume the same facts as in Example 3, except that X does not use the truck in X's trade or business, but instead uses it for personal purposes. X decides to sell the truck and on November 15, Year 1, X pays for an appraisal to determine a reasonable asking price. On February 15, Year 2, X sells the truck to Y. X is required to capitalize in Year 1 the amount paid to appraise the truck and, in Year 2, is required to offset the amount paid against the amount realized from the sale of the truck.

Example 6. Costs of abandoned sale of personal property not used in a trade or business. Assume the same facts as in Example 5, except that, instead of selling the truck on February 15, Year 2, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in Year 1 the amount paid to appraise the truck. Although the sale is abandoned in Year 2, X may not treat the amount paid to appraise the truck as a loss under section 165.
because the truck was not used in X's trade or business or in a transaction entered into for profit.

(e) Amount paid. In the case of a taxpayer using an accrual method of accounting, the terms amount paid and payment mean a liability incurred (within the meaning of §1.446-1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(f) Accounting method changes. Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446-1(e) and follow the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(g) Effective/applicability date. This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see §1.263(a)-1 in effect prior to January 1, 2012 (§1.263(a)-1 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(h) Expiration date. The applicability of this section expires on December 23, 2014.

[T.D. 9564, 76 FR 81101, Dec. 27, 2011]

§ 1.263(a)-2 Amounts paid to acquire or produce tangible property.

(a) through (h) [Reserved] For further guidance, see §§1.263(a)-2T(a) through (h).

(i) through (l) [Reserved] For further guidance, see §§1.263(a)-2T(i) through (l).

[T.D. 9564, 76 FR 81102, Dec. 27, 2011]

§ 1.263(a)-2T Amounts paid to acquire or produce tangible property (temporary).

(a) Overview. This section provides rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property. Paragraph (b) of this section contains definitions. Paragraph (c) of this section contains the rules for coordinating this section with other provisions of the Internal Revenue Code. Paragraph (d) of this section provides the general requirement to capitalize amounts paid to acquire or produce a unit of real or personal property. Paragraph (e) of this section provides the requirement to capitalize amounts paid to defend or perfect title to real or personal property. Paragraph (f) of this section provides the rules for determining the extent to which taxpayers must capitalize transaction costs related to the acquisition of property. Paragraph (g) of this section provides a de minimis rule for certain amounts paid for the acquisition or production of property. Paragraphs (h) and (i) of this section address the treatment and recovery of capital expenditures. Paragraph (j) of this section provides for changes in methods of accounting to comply with this section, and paragraphs (k) and (l) of this section provide the effective, applicability, and expiration dates for the rules under this section.

(b) Definitions. For purposes of this section, the following definitions apply:

(1) Amount paid. In the case of a taxpayer using an accrual method of accounting, the terms amount paid and payment mean a liability incurred (within the meaning of §1.446-1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) Personal property means tangible personal property as defined in §1.48-1(c).

(3) Real property means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property as defined in paragraph (b)(2) of this section. Any property that constitutes other tangible property under §1.48-1(d) is treated as real property for purposes of this section. Local law is not controlling in determining whether property is real property for purposes of this section.

(4) Produce means construct, build, install, manufacture, develop, create,
raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and §1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (b)(4) and are separately defined and addressed in §1.263A–3T.

(b)(4) and are separately defined and addressed in §1.263A–3T.

c) Coordination with other provisions of the Internal Revenue Code—(1) In general. Except as provided under the de minimis rule in paragraph (g) of this section, nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or regulations thereunder other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A requiring taxpayers to capitalize the direct and indirect costs of producing property or acquiring property for resale. See also section 195 requiring taxpayers to capitalize certain costs as start-up expenditures.

(2) Materials and supplies. Except as provided under the de minimis rule in paragraph (g) of this section, nothing in this section changes the treatment of amounts paid to acquire or produce property that is properly treated as materials and supplies under §1.162–3T.

d) Acquired or produced tangible property—(1) Requirement to capitalize. Except as provided in paragraph (g) of this section (providing the de minimis rule) and in §1.162–3T (relating to materials and supplies), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under §1.263(a)–3T(e)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures.

Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs as determined under paragraph (f) of this section, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d)). A taxpayer also must capitalize amounts paid to acquire real or personal property for resale and to produce real or personal property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) Examples. The rules of this section are illustrated by the following examples, in which it is assumed that the taxpayer does not apply the de minimis rule under paragraph (g) of this section:

Example 1. Acquisition of personal property. X purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume each cash register is a unit of property as determined under §1.263(a)–3T(e) and is not a material or supply under §1.162–3T. X must capitalize under this paragraph (d)(1) the amount paid to acquire each cash register.

Example 2. Acquisition of personal property that is a material or supply; coordination with §1.162–3T. X operates a fleet of aircraft. In Year 1, X acquires a stock of component parts, which it intends to use to maintain and repair its aircraft. X does not make elections under §1.162–3T(d) to treat the materials and supplies as capital expenditures. In Year 2, X uses the component parts in the repair and maintenance of its aircraft. Because the parts are materials and supplies under §1.162–3T, X is not required to capitalize the amounts paid for the parts under this paragraph (d)(1). Rather, X must apply the rules in §1.162–3T, governing the treatment of materials and supplies, to determine the treatment of these amounts.

Example 3. Acquisition of unit of personal property; coordination with §1.162–3T. X operates a rental business that rents out a variety of small individual items to customers (rental items). X maintains a supply of rental items on hand to replace worn or damaged items. X purchases a large quantity of rental items to be used in its business. Assume that each of these rental items is a unit of property under §1.263(a)–3T(e). Also assume that a portion of the rental items are materials and supplies under §1.162–3T(c)(1). Under paragraph (d)(1) of this section, X must capitalize the amounts paid for the rental items that are not materials and supplies under §1.162–3T(c)(1). However, X must apply the rules in §1.162–3T to determine the treatment of the rental items that are materials and supplies under §1.162–3T(c)(1).

Example 4. Acquisition or production cost. X purchases and produces jigs, dies, molds, and patterns for use in the manufacture of X’s products. Assume that each of these items is a unit of property as determined under §1.263(a)–3T(e) and is not a material and supply under §1.162–3T(c)(1). X is required to capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the jigs, dies, molds, and patterns.
See section 263A for the costs required to be capitalized to the property acquired or produced by X.

Example 5. Acquisition of land. X purchases a parcel of land. X must capitalize under paragraph (d)(1) of this section the amount paid to acquire the real estate. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 6. Acquisition of building. X purchases a building. X must capitalize under paragraph (d)(1) of this section the amount paid to acquire the building. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 7. Acquisition of property for resale and production of property for sale. X purchases goods for resale and produces other goods for sale. X must capitalize under paragraph (d)(1) of this section the costs required to be capitalized to the property acquired or produced by X.

Example 8. Production of building. X constructs a building. X must capitalize under paragraph (d)(1) of this section the amount paid to construct the building. See section 263A for the costs required to be capitalized to the real property produced by X.

Example 9. Acquisition of assets constituting a trade or business. Y owns tangible and intangible assets that constitute a trade or business. X purchases all the assets of Y. See §1.263(a)–4 for the treatment of amounts paid to acquire intangibles and §1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 1060 for special allocation rules for certain asset acquisitions.

Example 10. Work performed prior to placing the property in service. In Year 1, X purchases a building for use as a business office. Prior to placing the building in service, X incurs costs to repair cement steps, refinish wood floors, patch holes in walls, and paint the interiors and exteriors of the building. In Year 2, X places the building in service and begins using the building as its business office. Assume that the work that X performs does not constitute an improvement to the building or its structural components under §1.263(a)–9T. Under §1.263–9T(e)(5)(i), the building and its structural components is a single unit of property. Under paragraph (d)(1) of this section, the amounts paid must be capitalized as costs of acquiring the building because they were for work performed prior to X’s placing the building in service.

Example 11. Work performed prior to placing the property in service. In January Year 1, X purchases a new machine for use in an existing production line of its manufacturing business. Assume that the machine is a unit of property under §1.263(a)–3T(e) and is not a material or supply under §1.162–3T. After the machine is installed, X performs a critical test on the machine to ensure that it will operate in accordance with quality standards. On November 1, Year 1, the critical test is complete, and X places the machine in service. Under paragraph (d)(1) of this section, the amounts paid for the installation and the critical test performed before the machine is placed in service must be capitalized as costs of acquiring the machine. However, amounts paid for periodic quality control testing after X placed the machine in service are not required to be capitalized as a cost of acquiring the machine.

(e) Defense or perfection of title to property—(1) In general. Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property within the meaning of this section and must be capitalized. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) Examples. The following examples illustrate the rule of paragraph (e):

Example 1. Amounts paid to contest condemnation. X owns real property located in County. County files an eminent domain complaint condemning a portion of X’s property to use as a roadway. X hires an attorney to contest the condemnation. The amounts that X paid to the attorney must be capitalized because they were to defend X’s title to the property.

Example 2. Amounts paid to invalidate ordinance. X is in the business of quarrying and supplying for sale sand and stone in a certain municipality. Several years after X establishes its business, the municipality in which it is located passes an ordinance that prohibits the operation of X’s business. X incurs attorney’s fees in a successful prosecution of a suit to invalidate the municipal ordinance. X prosecutes the suit to preserve its business activities and not to defend X’s title in the property. Therefore, the attorney’s fees that X paid are not required to be capitalized under paragraph (e)(1) of this section. See section 263A for the rules requiring direct and allocable indirect costs (including otherwise deductible costs) to be capitalized to property produced or property acquired for resale.

Example 3. Amounts paid to challenge building line. The board of public works of a municipality establishes a building line across X’s business property, adversely affecting
the value of the property. X incurs legal fees in unsuccessfully litigating the establishment of the building line. The amounts X paid to the attorney must be capitalized because they were to defend X’s title to the property.

(f) Transaction costs—(1) In general. A taxpayer must capitalize amounts paid to facilitate the acquisition or production of real or personal property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale. See §1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See §1.167(a)–5 for allocations of facilitative costs between depreciable and non-depreciable property.

(2) Scope of facilitate—(i) In general. Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant but is not determinative. Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts specified in paragraph (f)(2)(ii) of this section.

(ii) Inherently facilitative amounts. An amount is paid in the process of investigating or otherwise pursuing the acquisition of real or personal property if the amount is inherently facilitative. An amount is inherently facilitative if the amount is paid for—

(A) Transporting the property (for example, shipping fees and moving costs);

(B) Securing an appraisal or determining the value or price of property;

(C) Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;

(D) Application fees, bidding costs, or similar expenses;

(E) Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);

(F) Examining and evaluating the title of property;

(G) Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;

(H) Conveying property between the parties, including sales and transfer taxes, and title registration costs;

(i) Finders’ fees or brokers’ commissions, including amounts paid that are contingent on the successful closing of the acquisition;

(j) Architectural, geological, engineering, environmental, or inspection services pertaining to particular properties; or

(K) Services provided by a qualified intermediary or other facilitator of an exchange under section 1031.

(iii) Special rule for acquisitions of real property—(A) In general. Except as provided in paragraph (f)(2)(ii) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire.

(B) Acquisitions of real and personal property in a single transaction. An amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of personal property facilitates the acquisition of such personal property even if such property is acquired in a single transaction that also includes the acquisition of real property subject to the special rule set out in paragraph (f)(2)(iii)(A) of this section. A taxpayer may use a reasonable allocation to determine which costs facilitate the acquisition of personal property and which costs relate to the acquisition of real property and are subject to the special rule of paragraph (f)(2)(iii)(A) of this section.

(iv) Employee compensation and overhead costs—(A) In general. For purposes of paragraph (f) of this section, amounts paid for employee compensation (within the meaning of §1.263(a)–
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4(e)(4)(ii)) and overhead are treated as amounts that do not facilitate the acquisition of real or personal property. See section 263A, however, for the treatment of employee compensation and overhead costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(B) Election to capitalize. A taxpayer may elect to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. For example, a taxpayer may elect to treat overhead, but not employee compensation, as amounts that facilitate the acquisition of property. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the acquisition in the taxpayer’s timely filed original Federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (f)(2)(ii)(A) with respect to each acquisition only by filing a request for a private letter ruling and obtaining the Commissioner’s consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer can demonstrate good cause for the revocation. An election may not be made or revoked through the filing of an application for change in accounting method or before obtaining the Commissioner’s consent to make the late election or to revoke the election, by filing an amended Federal income tax return.

(3) Treatment of transaction costs—(i) In general. All amounts paid to facilitate the acquisition or production of real or personal property are capital expenditures. Facilitative amounts allocable to real or personal property are capital expenditures related to such property even if the property is not eventually acquired or produced. Inherently facilitative amounts allocable to real or personal property not acquired may be allocated to those properties and recovered as appropriate in accordance with the applicable provisions of the Internal Revenue Code and the regulations thereunder (for example, sections 165, 167, or 168). See paragraph (i) of this section for the recovery of capitalized amounts.

(4) Examples. The following examples illustrate the rules of paragraph (f) of this section:

Example 1. Broker’s fees to facilitate an acquisition. X decides to purchase building A and pays amounts to third-party contractors for a termitie inspection and an environmental survey of building A. Under paragraph (f)(2)(i)(J) of this section, X must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

Example 2. Inspection and survey costs to facilitate an acquisition. X purchases all the assets of Y and, in connection with the purchase, hires a transportation company to move storage tanks from Y’s plant to X’s plant. Under paragraph (f)(2)(i)(J) of this section, X must capitalize the amount paid to move the storage tanks from Y’s plant to X’s plant because this cost is inherently facilitative to the acquisition of personal property.

Example 3. Moving costs to facilitate an acquisition. X purchases all the assets of Y and, in connection with the purchase, hires a real estate broker to find a suitable building. X pays fees to the broker to find property for X to acquire. Under paragraph (f)(2)(i)(I) of this section, X must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

Example 4. Geological and geophysical costs: coordination with other provisions. X is in the business of exploring, purchasing, and developing properties in the United States for the production of oil and gas. X considers acquiring a particular property but first incurs costs for the services of an engineering firm to perform geological and geophysical studies to determine if the property is suitable for oil or gas production. Assume that the amounts that X paid for the geological and geophysical services are inherently facilitative to the acquisition of real property under paragraph (f)(2)(i)(J) of this section. X is not required to include those amounts in

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the basis of the real property acquired. Rather, under paragraph (c) of this section, X must capitalize these costs separately and amortize such costs as required under section 167 (addressing the amortization of geological and geophysical expenditures).

Example 5. Scope of facilitate. X is in the business of providing legal services to clients. X hires, and incurs fees for, an interior designer to shop for, evaluate, and make recommendations to X regarding which new table to acquire. Under paragraphs (f)(1) and (2) of this section, X must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

Example 6. Transaction costs allocable to multiple properties. X, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. X considers various properties on highway A in state B. X incurs fees for the services of an architect to advise and evaluate the suitability of the sites for the type of facility that X intends to construct on the selected site. X must capitalize the architect fees as amounts paid to acquire land because these amounts are inherently facilitative to the acquisition of land under paragraph (f)(2)(ii)(J) of this section.

Example 7. Transaction costs allocable to multiple properties. X, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. X considers various properties on highway A in state B. X incurs fees for the services of an architect to advise and evaluate the suitability of the sites for the type of facility that X intends to construct on the selected site. X must capitalize the architect fees as amounts paid to acquire land because these amounts are inherently facilitative to the acquisition of land under paragraph (f)(2)(ii)(J) of this section but are allocable to the acquisition of land under paragraph (f)(2)(ii)(J) of this section.

Example 8. Special rule for acquisitions of real property. X owns several retail stores. X decides to examine the feasibility of opening a new store in city A. In October, Year 1, X hires and incurs costs for a development consultant to study city A and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that X should consider for purposes of locating a new store. In December, Year 1, X decides to consider whether to purchase real property in city A and which property to acquire. X hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. In March, Year 2, X decides to acquire one of these two sites for the location of its new store. At the same time, X determines not to acquire the other site. Under paragraph (f)(2)(iii) of this section, X is not required to capitalize amounts paid to the development consultant in Year 1 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire and the amounts are not inherently facilitative costs under paragraph (f)(2)(ii) of this section. However, X must capitalize amounts paid to the appraiser in Year 1 because the appraisal costs are inherently facilitative costs under paragraph (f)(2)(ii)(B) of this section. In Year 2, X must include the appraisal costs allocable to property acquired in the basis of the property acquired and may recover the appraisal costs allocable to the property not acquired in accordance with paragraphs (f)(3)(i) and (i) of this section.

Example 9. Employee compensation and overhead. X, a freight carrier, maintains an acquisition department whose sole function is to arrange for the purchase of vehicles and aircraft from manufacturers or other parties to be used in its freight carrying business. As provided in paragraph (f)(2)(iv)(A) of this section, X is not required to capitalize any portion of the compensation paid to employees in its acquisition department or any portion of its overhead allocable to its acquisition department. However, under paragraph (f)(2)(iv)(B) of this section, X may elect to capitalize the compensation and overhead costs allocable to the acquisition of a vehicle or aircraft by treating these amounts as costs that facilitate the acquisition of that property in its timely filed original federal income tax return for the year the amounts are paid.

(g) De minimis rule—(1) In general. Except as otherwise provided in this paragraph (g), a taxpayer is not required to capitalize under paragraph (d)(1) of this section nor treat as a material or supply under §1.162–3T(a) amounts paid for the acquisition or production (including any amounts paid to facilitate the acquisition or production) of a unit of property (as determined under §1.263(a)–3T(e)) or for the acquisition or production of any material or supply (as defined in §1.162–3T(c)(1)) if—

(i) The taxpayer has an applicable financial statement (as defined in paragraph (g)(6) of this section); and

(ii) The taxpayer has at the beginning of the taxable year written accounting procedures treating as an expense for non-tax purposes the

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amounts paid for property costing less than a certain dollar amount;

(iii) The taxpayer treats the amounts paid during the taxable year as an expense on its applicable financial statement in accordance with its written accounting procedures; and

(iv) The total aggregate of amounts paid and not capitalized under paragraph (g)(1) of this section and §1.162–3T(f) (materials and supplies) for the taxable year are less than or equal to the greater of—

(A) 0.1 percent of the taxpayer’s gross receipts for the taxable year as determined for Federal income tax purposes; or

(B) 2 percent of the taxpayer’s total depreciation and amortization expense for the taxable year as determined in its applicable financial statement.

(2) Exceptions to de minimis rule. The de minimis rule in paragraph (g)(1) of this section does not apply to the following:

(i) Amounts paid for property that is or is intended to be included in inventory property; and

(ii) Amounts paid for land.

(3) Additional rules. Property to which a taxpayer applies the de minimis rule contained in paragraph (g) of this section is not treated upon sale or other disposition as a capital asset under section 1221 or as property used in the trade or business under section 1231. The cost of property to which a taxpayer properly applies the de minimis rule contained in paragraph (g) of this section is not required to be capitalized under section 263A to a separate unit of property but may be required to be capitalized as a cost of other property if incurred by reason of the production of the other property. See, for example, §1.263A–1(e)(3)(ii)(R) requiring taxpayers to capitalize the cost of tools and equipment allocable to property produced or property acquired for resale.

(4) Election to capitalize. A taxpayer may elect not to apply the de minimis rule contained in paragraph (g)(1) of this section. An election made under this paragraph (g)(4) may apply to any unit of property during the taxable year to which paragraph (g)(1) of this section would apply (but for the election under this paragraph (g)(4)). A taxpayer makes the election by capitalizing the amounts paid to acquire or produce the unit of property in the taxable year the amounts are paid and by beginning to recover the costs when the unit of property is placed in service by the taxpayer for the purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the regulations thereunder. A taxpayer must make this election on its timely filed original Federal income tax return (including extensions) for the taxable year the unit of property is placed in service by the taxpayer for the purposes of determining depreciation. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (g)(4) with respect to a unit of property only by filing a request for a private letter ruling and obtaining the Commissioner’s consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer can demonstrate good cause for the revocation. An election may not be made or revoked through the filing of an application for change in accounting method or by filing an amended Federal income tax return.

(5) Materials and supplies. A taxpayer must treat amounts paid to acquire or produce a unit of property that is a material or supply as defined under §1.162–3T(c)(1) under §1.162–3T unless the taxpayer elects under §1.162–3T(f) to apply the de minimis rule to that property under this paragraph (g). Property to which a taxpayer applies the de minimis rule contained in paragraph (g) of this section is not treated as a material or supply under §1.162–3T.

(6) Definition of applicable financial statement. For purposes of this section (g), the taxpayer’s applicable financial statement is the taxpayer’s financial statement listed in paragraphs (g)(6)(i) through (iii) of this section that has the highest priority (including within paragraph (g)(6)(ii) of this section). The financial statements are, in descending priority—
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(i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);

(ii) A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for—

(A) Credit purposes;

(B) Reporting to shareholders, partners, or similar persons; or

(C) Any other substantial non-tax purpose; or

(iii) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agencies (other than the SEC or the Internal Revenue Service).

(7) Application to consolidated group member. If the taxpayer is a member of a consolidated group for federal income tax purposes and the member’s financial results are reported on the applicable financial statement (as defined in paragraph (g)(6) of this section) for the consolidated group then, for purposes of paragraphs (g)(1)(ii) and (g)(1)(iii) of this section, the written accounting procedures provided for the group and utilized for the group’s applicable financial statement may be treated as the written accounting procedures of the member.

(8) Examples. The following examples illustrate the rule of this paragraph (g):

Example 1. De minimis rule. X purchases 10 printers at $200 each for a total cost of $2,000. Assume that each printer is a unit of property under § 1.263(a)–3T(e) and is not a material or supply under § 1.162–3T. X has an applicable financial statement and a written policy at the beginning of the taxable year to expense amounts paid for property costing less than $500. X treats the amounts paid for the printers as an expense on its applicable financial statement. Assume that the total aggregate amounts treated as de minimis and not capitalized by X under paragraphs (g)(1)(i), (ii), and (iii) of this section, including the amounts paid for the printers, are less than or equal to the greater of 0.1 percent of total gross receipts or 2 percent of X’s total financial statement depreciation under paragraph (g)(1)(iv) of this section. X is not required to capitalize the amounts paid for the 10 printers under paragraph (g)(1) of this section.

Example 2. De minimis rule not met. X is a member of a consolidated group for federal income tax purposes. X’s financial statements for the affiliated group are reported on the consolidated applicable financial statements for the affiliated group. X’s affiliated group has a written policy at the beginning of Year 1, which is followed by X, to expense amounts paid for property costing less than $500. In Year 1, X pays $160,000 to purchase 400 computers at $400 each. Assume that each computer is a unit of property under § 1.263(a)–3T(e), is not a material or supply under § 1.162–3T, and that X intends to treat the cost of only the computers as de minimis under paragraph (g)(1) of this section. X treats the amounts paid for the computers as an expense on the applicable financial statements for the affiliated group. For its Year 1 taxable year, X has gross receipts of $125,000,000 for Federal tax purposes and reports $7,000,000 of it’s own depreciation and amortization expense on the affiliated group’s applicable financial statement. Thus, in order to meet the criteria of paragraph (g)(1)(iv) of this section for Year 1, the total aggregate amounts paid and not capitalized by X under paragraphs (g)(1)(i), (ii), and (iii) of this section must be less than or equal to the greater of $125,000,000 (0.1 percent of X’s total gross receipts of $125,000,000) or $140,000 (2 percent of X’s total depreciation and amortization of $7,000,000). Because X pays $160,000 for the computers and this amount exceeds $140,000, the greater of the two limitations provided in paragraph (g)(1)(iv) of this section, X may not apply the de minimis rule under paragraph (g)(1) of this section to the total amounts paid for the 400 computers.

Example 3. De minimis rule; election to capitalize. Assume the same facts as in Example 2, except that X makes an election under paragraph (g)(4) of this section to capitalize $20,000, the amounts paid to acquire 50 of the 400 computers purchased in Year 1. Under these facts, the $140,000 paid by X in Year 1 for the remaining 350 computers qualifies for the de minimis rule under paragraph (g)(1) of this section because the amount is equal to 2 percent of X’s total depreciation and amortization ($140,000), the greater of the two amounts calculated under paragraph (g)(1)(iv) of this section. Accordingly, X is not required to capitalize the amounts paid to acquire the 350 computers in Year 1.

Example 4. Election to apply de minimis rule to certain materials and supplies. (1) X is a corporation that provides consulting services to its customers. X has an applicable financial statement and a written policy at the beginning of the taxable year to expense amounts paid for property costing $500 or less. In Year 1, X purchases 200 computers at $500 each for a total cost of $100,000. Assume that each computer is a unit of property under
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$1.263(a)-3T(e) and is not a material or supply under §1.162-3T. In addition, X purchases 200 office chairs at $100 each for a total cost of $20,000 and 250 customized briefcases at $80 each for a total cost of $20,000. Assume that each office chair and each briefcase is a material or supply under §1.162-3T(c)(1). In Year 1, X also acquires 10 books at $100 each, which are also materials and supplies under §1.162-3T(c)(1). X makes the election under §1.162-3T(f) to apply the de minimis rule to the office chairs and briefcases, but does not make that election for the books and treats the books as materials and supplies in accordance with the provisions of §1.162-3T. X treats the amounts paid for the computers, office chairs, and briefcases as expenses on its applicable financial statement. Assume also that for Year 1, the amounts that X paid for the computers, office chairs, and briefcases are the only amounts that X intends to treat as de minimis costs not capitalized under paragraph (g)(1) of this section. For its Year 1 taxable year, X has gross receipts of $125,000,000 and reports $7,000,000 of depreciation and amortization on its applicable financial statement.

(i) Recovery of capitalized amounts—(1) In general. Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable provisions of the Internal Revenue Code and regulations relating to the use, sale, or disposition of property.

(2) Examples. The following examples illustrate the rule of paragraph (i)(1) of this section. Assume that X does not apply the de minimis rule under paragraph (g) of this section.

Example 1. Recovery when property placed in service. X owns a 10-unit apartment building. The refrigerator in one of the apartments stops functioning, and X purchases a new refrigerator to replace the old one. X pays for the acquisition, delivery, and installation of the new refrigerator. Assume that the refrigerator is the unit of property, as determined under §1.263(a)-3T(e), and is not a material or supply under §1.162-3T. Under paragraph (d)(1) of this section, X is required to capitalize the amounts paid for the acquisition, delivery, and installation of the refrigerator. Under paragraph (i) of this section, the capitalized amounts are recovered through depreciation, which begins when the refrigerator is placed in service by X.

Example 2. Recovery when property used in the production of property. X operates a plant where it manufactures widgets. X purchases a tractor loader to move raw materials into and around the plant for use in the manufacturing process. Assume that the tractor loader is a unit of property, as determined under §1.263(a)-3T(e), and is not a material or supply under §1.162-3T. Under paragraph (d)(1) of this section, X is required to capitalize the amounts paid for the tractor loader. Under paragraph (i) of this section, the capitalized amounts are recovered through depreciation, which begins when X places the tractor loader in service. However, because the tractor/loader is used in the production of property, under section 263A the cost recovery (that is, the depreciation) on the capitalized amounts must be capitalized to X’s property produced, and, consequently, recovered through cost of goods sold. See §1.263A-1(e)(3)(ii)(B).

(j) Accounting method changes. Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to
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a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446–1(e) and follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner’s consent to change its accounting method.

(k) Effective/applicability date. Except for paragraphs (f)(2)(iii), (f)(2)(iv), (f)(3)(ii), and (g) of this section, this section generally applies to taxable years beginning on or after January 1, 2012. Paragraphs (f)(2)(iii), (f)(2)(iv), (f)(3)(ii), and (g) of this section apply to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see §1.263(a)–2 in effect prior to January 1, 2012 (§1.263(a)–2 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(l) Expiration Date. The applicability of this section expires on December 23, 2014.


§ 1.263(a)–3 Amounts paid to improve tangible property.

(a) and (b) [Reserved] For further guidance, see §1.263(a)–3T(a) and (b).

(c) through (q) [Reserved] For further guidance, see §§1.263(a)–3T(c) through (q).

[T.D. 9564, 76 FR 81107, Dec. 27, 2011]

§ 1.263(a)–3T Amounts paid to improve tangible property (temporary).

(a) Overview. This section provides rules for applying section 263(a) to amounts paid to improve tangible property. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules for coordinating this section with other provisions of the Internal Revenue Code. Paragraph (d) of this section provides the requirement to capitalize amounts paid to improve tangible property and provides the general rules for determining whether a unit of property is improved. Paragraph (e) of this section provides the rules for determining the appropriate unit of property. Paragraph (f) of this section provides special rules for determining improvement costs in particular contexts. Paragraph (g) provides a safe harbor for routine maintenance costs. Paragraph (h) of this section provides rules for determining whether amounts paid result in betterments to the unit of property. Paragraph (i) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (j) of this section provides an optional regulatory accounting method. Paragraph (k) of this section provides for a repair allowance or other methods of accounting identified in published guidance. Paragraphs (m) through (o) of this section provide additional rules related to these provisions. Paragraphs (p) and (q) of this section provides the effective/applicability and expiration dates for the rules in this section.

(b) Definitions. For purposes of this section, the following definitions apply:

(1) Amount paid. In the case of a taxpayer using an accrual method of accounting, the terms amounts paid and payment mean a liability incurred (within the meaning of §1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) Personal property means tangible personal property as defined in §1.48–1(c).

(3) Real property means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property as defined in paragraph (b)(2) of this section. Any property that constitutes other tangible property under §1.48–1(d) is also treated as real property for purposes of this section. Local law is not controlling in determining whether property is real property for purposes of this section.

(4) Owner means the taxpayer that has the benefits and burdens of ownership of the unit of property for Federal income tax purposes.
(c) Coordination with other provisions of the Internal Revenue Code—(1) In general. Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or the regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A requiring taxpayers to capitalize the direct and indirect costs of producing property or acquiring property for resale.

(2) Materials and supplies. A material or supply as defined in §1.162–3T(c)(1) that is acquired and used to improve a unit of tangible property is subject to this section and is not treated as a material or supply under §1.162–3T.

(3) Exception for amounts subject to de minimis rule. A taxpayer is not required to capitalize amounts paid to acquire or produce units of property used in improvements under paragraph (d) of this section (including materials and supplies used in improvements) if these amounts are properly deducted under the de minimis rule of section §1.263(a)–2(g).

(3) Example. The following example illustrates the rules of this paragraph (c):

Example. Railroad rolling stock. X is a railroad that properly treats amounts paid for the rehabilitation of railroad rolling stock as deductible expenses under section 263(d). X is not required to capitalize the amounts paid because nothing in this section changes the treatment of amounts specifically provided for under section 263(d).

(d) Requirement to capitalize amounts paid for improvements. Except as provided in the optional regulatory accounting method in paragraph (k) of this section or under any other accounting method published in accordance with paragraph (l) of this section, a taxpayer generally must capitalize the aggregate of related amounts (as defined in paragraph (f)(4) of this section) paid to improve a unit of property owned by the taxpayer. However, see paragraph (f)(1) of this section for the treatment of amounts paid to improve leased property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale; section 1016 for adding capitalized amounts to the basis of the unit of property; and section 168 for the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer—

(1) Result in a betterment to the unit of property (see paragraph (h) of this section);

(2) Materials and supplies. A material or supply as defined in §1.162–3T(c)(1) that is acquired and used to improve a unit of tangible property is subject to this section and is not treated as a material or supply under §1.162–3T.

(3) Exception for amounts subject to de minimis rule. A taxpayer is not required to capitalize amounts paid to acquire or produce units of property used in improvements under paragraph (d) of this section (including materials and supplies used in improvements) if these amounts are properly deducted under the de minimis rule of section §1.263(a)–2(g).

(3) Example. The following example illustrates the rules of this paragraph (c):

Example. Railroad rolling stock. X is a railroad that properly treats amounts paid for the rehabilitation of railroad rolling stock as deductible expenses under section 263(d). X is not required to capitalize the amounts paid because nothing in this section changes the treatment of amounts specifically provided for under section 263(d).

(d) Requirement to capitalize amounts paid for improvements. Except as provided in the optional regulatory accounting method in paragraph (k) of this section or under any other accounting method published in accordance with paragraph (l) of this section, a taxpayer generally must capitalize the aggregate of related amounts (as defined in paragraph (f)(4) of this section) paid to improve a unit of property owned by the taxpayer. However, see paragraph (f)(1) of this section for the treatment of amounts paid to improve leased property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale; section 1016 for adding capitalized amounts to the basis of the unit of property; and section 168 for the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer—

(1) Result in a betterment to the unit of property (see paragraph (h) of this section);

(2) Materials and supplies. A material or supply as defined in §1.162–3T(c)(1) that is acquired and used to improve a unit of tangible property is subject to this section and is not treated as a material or supply under §1.162–3T.

(3) Exception for amounts subject to de minimis rule. A taxpayer is not required to capitalize amounts paid to acquire or produce units of property used in improvements under paragraph (d) of this section (including materials and supplies used in improvements) if these amounts are properly deducted under the de minimis rule of section §1.263(a)–2(g).

(3) Example. The following example illustrates the rules of this paragraph (c):

Example. Railroad rolling stock. X is a railroad that properly treats amounts paid for the rehabilitation of railroad rolling stock as deductible expenses under section 263(d). X is not required to capitalize the amounts paid because nothing in this section changes the treatment of amounts specifically provided for under section 263(d).
(ii) Application of improvement rules to a building. An amount is paid for an improvement to a building under paragraphs (d) and (f)(1)(iii) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to any of the following:

(A) Building structure. A building structure consists of the building (as defined in §1.48–1(e)(1)), and its structural components (as defined in §1.48–1(e)(2)), other than the structural components designated as building systems in paragraph (e)(2)(ii)(B) of this section.

(B) Building system. Each of the following structural components (as defined in §1.48–1(e)(2)), including the components thereof, constitutes a building system that is separate from the building structure, and to which the improvement rules must be applied—

(1) Heating, ventilation, and air conditioning (‘‘HVAC’’) systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);

(2) Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);

(3) Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures);

(4) All escalators;

(5) All elevators;

(6) Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire fighting equipment, such as extinguishers, hoses);

(7) Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit);

(8) Gas distribution system (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures); and

(9) Other structural components identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter) that are excepted from the building structure under paragraph (e)(2)(ii)(A) of this section and are specifically designated as building systems under this section.

(iii) Condominium—(A) In general. In the case of a taxpayer that is the owner of an individual unit in a building with multiple units (such as a condominium), the unit of property is the individual unit owned by the taxpayer and the structural components (as defined in §1.48–1(e)(2)) that are part of the unit (condominium).

(B) Application of improvement rules to a condominium. An amount is paid for an improvement to a condominium under paragraph (d) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) that is part of the condominium or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the condominium. In the case of the condominium management association, the association must apply the improvement rules to the building structure or to any building system as determined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(iv) Cooperative—(A) In general. In the case of a taxpayer that has an ownership interest in a cooperative housing corporation, the unit of property is the portion of the building in which the taxpayer has possessory rights and the structural components (as defined in §1.48–1(e)(2)) that are part of the portion of the building subject to the taxpayer’s possessory rights (cooperative).

(B) Application of improvement rules to a cooperative. An amount is paid for an
improvement to a cooperative under paragraph (d) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to the portion of the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) in which the taxpayer has possessory rights or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the portion of the building structure subject to the taxpayer’s possessory rights. In the case of a cooperative housing corporation, the corporation must apply the improvement rules to the building structure or to any building system as determined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(v) Leased building—(A) In general. In the case of a taxpayer that is a lessee of all or a portion of a building (such as an office, floor, or certain square footage), the unit of property is each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion.

(B) Application of improvement rules to a leased building. An amount is paid for an improvement to a leased building or a leased portion of a building under paragraphs (d) and (f)(1)(ii) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to any of the following:

(1) Entire building. In the case of a taxpayer that is a lessee of an entire building, the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) or any building system (as defined under paragraph (e)(2)(ii)(B) of this section) to which the expenditure relates.

(2) Portion of a building. In the case of a taxpayer that is a lessee of a portion of a building (such as an office, floor, or certain square footage), the portion of the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) subject to the lease or the portion of any building system (as defined under paragraph (e)(2)(ii)(B) of this section) associated with that portion of the leased building structure.

(3) Property other than building—(i) In general. Except as otherwise provided in paragraphs (e)(3), (e)(4), (e)(5), and (f)(1) of this section, in the case of real or personal property other than property described in paragraph (e)(2) of this section, all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

(ii) Plant property—(A) Definition. For purposes of this paragraph (e) of this section, the term plant property means functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

(B) Unit of property for plant property. In the case of plant property, the unit of property determined under the general rule of paragraph (e)(3)(i) of this section is further divided into smaller units comprised of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

(iii) Network assets—(A) Definition. For purposes of this paragraph (e), the term network assets means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be included as building structure or building systems under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section, nor does it include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

(B) Unit of property for network assets. In the case of network assets, the unit
of property is determined by the taxpayer’s particular facts and circumstances except as otherwise provided in published guidance in the Federal Register or in the Internal Revenue Bulletin (see §601.601(d)(2)(1)(ii)(b) of this chapter). For these purposes, the functional interdependence standard provided in paragraph (e)(3)(i) of this section is not determinative.

(iv) Leased property other than buildings. In the case of a taxpayer that is a lessee of real or personal property other than property described in paragraph (e)(2) of this section, the unit of property for the leased property is determined under paragraphs (e)(3)(1), (ii), (iii), and (e)(5) of this section except that, after applying the applicable rules under those paragraphs, the unit of property may not be larger than the unit of leased property.

(4) Improvements to property. An improvement to a unit of property, other than a lessee improvement as determined under paragraphs (e)(3)(1), (ii), (iii), and (e)(5) of this section except that, after applying the applicable rules under those paragraphs, the unit of property may not be larger than the unit of leased property.

(5) Additional rules—(i) Year placed in service. Notwithstanding the unit of property determination under paragraph (e)(3) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if, at the time the unit of property is initially placed in service by the taxpayer, the taxpayer has properly treated the component as being within a different class of property under section 168(e) (MACRS classes) than the class of the unit of property of which the component is a part, or the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method of the unit of property of which the component is a part.

(ii) Change in subsequent taxable year. Notwithstanding the unit of property determination under paragraphs (e)(2), (3), (4), or (5)(i) of this section, in any taxable year after the unit of property is initially placed in service by the taxpayer, if the taxpayer or the Internal Revenue Service changes the treatment of that property (or any portion thereof) to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the use of the property), then the taxpayer must change the unit of property determination for that property (or the portion thereof) under this section to be consistent with the change in treatment for depreciation purposes. Thus, for example, if a portion of a unit of property is properly reclassified to a MACRS class different from the MACRS class of the unit of property of which it was previously treated as a part, then the reclassified portion of the property should be treated as a separate unit of property for purposes of this section.

(6) Examples. The rules of this paragraph (e) are illustrated by the following examples, in which it is assumed that the taxpayer has not made a general asset account election with regard to property or accounted for property in a multiple asset account. In addition, unless the facts specifically indicate otherwise, assume that the additional rules in paragraph (e)(5) of this section do not apply:

Example 1. Building systems. X owns an office building that contains a HVAC system. The HVAC system incorporates ten roof-mounted units that service different parts of the building. The roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building’s interior. X pays an amount for labor and materials for work performed on the roof-mounted units. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(i) of this section, the entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for work on the roof-mounted units results in an improvement (for example, a betterment) to the HVAC system, X must treat this amount as an improvement to the building.

Example 2. Building systems. X owns a building that it uses in its retail business. The
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building contains two elevator banks in different locations in its building. Each elevator bank contains three elevators. X pays an amount for labor and materials for work performed on the elevators. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(i) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. Under paragraph (e)(2)(i)(B)(5) of this section, all of the elevators, including all their components, comprise a building system. Therefore, under paragraph (e)(2)(i) of this section, if an amount paid by X for work on the elevators results in an improvement (for example, a betterment) to the entire elevator system, X must treat these amounts as an improvement to the building.

Example 4. Building structure and systems; condominium. X owns a condominium unit in a condominium office building. X uses the condominium unit in its business of providing medical services. The condominium unit contains two restrooms, each of which contains a sink, a toilet, water and drainage pipes and bathroom fixtures. X pays an amount for labor and materials to perform work on the pipes, sinks, toilets, and plumbing fixtures that are part of the condominium unit. Under paragraph (e)(2)(ii) of this section, X must treat the individual unit that it owns, including the structural components that are part of that unit, as a single unit of property. As provided under paragraph (e)(2)(ii)(B) of this section, an amount is paid for an improvement to the condominium if it results in an improvement to the building structure that is part of the unit or to a portion of any designated building system that is part of the unit. Under paragraph (e)(2)(ii)(B)(2) of this section, the pipes, sinks, toilets, and plumbing fixtures that are part of X’s unit comprise the plumbing system for the condominium unit. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for work on pipes, sinks, toilets, and plumbing fixtures results in an improvement (for example, a betterment) to the portion of the plumbing system that is part of X’s condominium unit, X must treat this amount as an improvement to the condominium.

Example 5. Plant property; discrete and major function. X is an electric utility company that operates a power plant to generate electricity. The power plant includes a structure that is not a building under §1.48–1(e)(1), four pulverizers that grind coal, one boiler that produces steam, one turbine that converts the steam into mechanical energy, and one generator that converts mechanical energy into electrical energy. In addition, the turbine contains a series of blades that cause the turbine to rotate when affected by the steam. Because the plant is composed of real and personal tangible property other than a building, the unit of property for the generating equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section, the initial unit of property is the entire plant because the components of the plant are functionally interdependent. However, because the power plant is plant property under paragraph (e)(3)(ii) of this section, the initial unit of property is further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the plant. Under this paragraph, X must treat the structure, the boiler, the turbine, and the generator each as a separate unit of property, and each of the four pulverizers as a separate unit of property because each of these components performs a discrete and major function within the power plant. X is not required to treat components, such as the turbine blades, as separate units of property because each of these components does not perform a discrete and major function within the plant.

Example 6. Plant property; discrete and major function. X is engaged in a uniform and linen rental business. X owns and operates a plant that utilizes many different machines and

office building. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(i) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for the addition of an extension to the office building results in an improvement (for example, a betterment) to the building structure, X must treat this amount as an improvement to the building. In addition, because the equipment contained within the office building constitutes property other than the building, the units of property for the office equipment are initially determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of the groups of components that are functionally interdependent.

Example 6. Plant property; discrete and major function. X is engaged in a uniform and linen rental business. X owns and operations...
equipment in an assembly line-like process to treat, launder, and prepare rental items for its customers. X utilizes two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens. Both lines incorporate several sorters, boilers, washers, dryers, irons, folders, and waste water treatment systems. Because the laundering equipment contained within the plant is property other than a building, the initial unit of property for the laundering equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial units of property are each laundering line because each line is functionally independent and is comprised of components that are functionally interdependent. However, because each line is comprised of plant property under paragraph (e)(3)(ii) of this section, X must further divide these initial units of property into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Under paragraph (e)(3)(ii) of this section, X must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a separate unit of property because each of these components performs a discrete and major function within the line.

Example 7. Plant property; industrial process. X operates a restaurant that prepares and serves food to retail customers. Within its restaurant, X has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that X serves to its customers. Because the tortilla-making equipment is property other than a building, the unit of property for the equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire tortilla-making equipment because the various components of the equipment are functionally interdependent. The equipment is not plant property under paragraph (e)(3)(ii) of this section because the equipment is not used in an industrial process, as it performs a small-scale function in X’s retail restaurant operations. Thus, X is not required to further divide the equipment into separate units of property based on the components that perform discrete and major functions.

Example 8. Personal property. X owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries and trucks. X acquired a locomotive with all its components and treated all the components of the locomotive as being within the same class of property under section 168(e) and depreciated all the components using the same depreciation method. Because X’s locomotive is property other than a building, the initial unit of property is determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent.

Example 9. Personal property. X provides legal services to its clients. X purchased a laptop computer and a printer for its employees to use in providing legal services. When X placed the computer and printer into service, X treated the computer and printer and all their components as being within the same class of property under section 168(e) and depreciated all the components using the same depreciation method. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer).

Example 10. Building structure and systems; leased building. X is a retailer of consumer products. X conducts its retail sales in a building that it leases from Y. The leased building consists of the building structure (including the floor, walls, and a roof) and various building systems, including a plumbing system, an electrical system, a HVAC system, a security system, and a fire protection and prevention system. X pays an amount for labor and materials to perform work on the HVAC system of the leased building. Under paragraph (e)(2)(v)(A) of this section, because X leases the entire building, X must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B) of this section, an amount paid by X for work on the HVAC system results in an improvement to the heated and air conditioning system in the leased building. X must treat this amount as an improvement to the entire leased building.

Example 11. Production of real property related to leased property. Assume the same facts as in Example 10, except that X receives
Example 12. Leasehold improvements; construction allowance used for lessor-owned improvements. Assume the same facts as Example 11, except that under the terms of the lease Y, the lessor, is treated as the owner of any property constructed on the leased premises. Because Y, the lessor, is the owner of the driveway and the driveway is real property other than a building, all the components of the driveway that are functionally interdependent are a single unit of property under paragraphs (e)(3)(i) and (e)(3)(iv) of this section.

Example 13. Buildings and structural components. X provides consulting services to its clients. X conducts its consulting services business in two office spaces in the same building, each of which it leases from Y under separate agreements. Each office space contains a separate HVAC unit, which is part of the leased property. Both lease agreements provide that X is responsible for maintaining, repairing, and replacing the HVAC conditioning system that is part of the leased property. X pays amounts to perform work on the HVAC units in each office space. Because X leases two separate office spaces subject to two leases, X must treat the portion of the building structure and the structural components subject to each lease as a separate unit of property under paragraph (e)(2)(v)(A) of this section. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid for an improvement to a leased unit of property, if it results in an improvement to the leased portion of the building structure or the associated portion of any designated building system subject to each lease. Under paragraphs (e)(2)(v)(B)(I) and (e)(2)(ii)(B)(I) of this section, X must treat the HVAC unit associated with the leased office space as a building system of that leased space and the HVAC unit associated with the second leased office space as a building system of that second leased space. Thus, under paragraph (e)(2)(ii)(B) of this section, if the amount paid by X for work on the HVAC unit in one leased space results in an improvement (for example, a betterment) to the HVAC system that is part of that one leased space, then X must treat the amount as an improvement to that one unit of leased property.

Example 14. Leased property; personal property. X is engaged in the business of transporting passengers on private jet aircraft. To conduct its business, X leases several aircraft from Y. Assume that each aircraft is plant property or a network asset. Under paragraph (e)(3)(iv) of this section, X must treat all of the components of each leased aircraft that are functionally interdependent as a single unit of property. Thus, X must treat each leased aircraft as a single unit of property.

Example 15. Improvement property. (i) X is a retailer of consumer products. In Year 1, X purchases a building from Y, which X intends to use as a retail sales facility. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system.

(ii) In Year 2, X pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that the extension involves the addition of walls, floors, roof, and doors, but does not include the addition or extension of any building systems described in paragraph (e)(2)(ii)(B) of this section. Also assume that the amount paid to build the extension results in a betterment to the building structure under paragraph (h) of this section, and is therefore treated as an amount paid for an improvement to the entire building under paragraph (e)(2)(ii) of this section. Accordingly, X capitalizes the amount paid as an improvement to the building under paragraph (d) of this section. Under paragraph (e)(4) of this section, the extension is not a unit of property separate from the building, the unit of property improved. Thus, to determine whether any future expenditure constitutes an improvement to the building under paragraph (e)(2)(ii), X must determine whether the expenditure constitutes an improvement to the building structure, including the building extension, or any of the designated building systems.

Example 16. Personal property; additional rules. X is engaged in the business of transporting freight throughout the United States. To conduct its business, X owns a fleet of truck tractors and trailers. Each tractor and trailer is comprised of various components, including tires. X purchased a truck tractor with all of its components, including tires. The tractor tires have an average useful life to X of more than one year. At the time X placed the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes under section 168.
X properly treated the tractor (excluding the cost of the tires) as 3-year property and the tractor tires as 5-year property under section 168(e). Because X’s tractor is property other than property that the initial units of property for the tractor are determined under the general rule in paragraph (e)(3)(i) of this section, and are comprised of all the components that are, as a single unit of property because the tractor and the tires are functionally interdependent. Under this rule, X must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor). However, under paragraph (e)(5)(ii) of this section, X must treat the tractor and tires as separate units of property because X properly treated the tires as being within a different class of property under section 168(e).

Example 17. Additional rules; change in subsequent year. X is engaged in the business of leasing nonresidential real property to retailers. In Year 1, X acquired and placed in service a building and parking lot for use in its retail leasing operation. In Year 5, in order to accommodate the needs of a new lessee, X incurred costs to improve the building structure. X capitalized the costs of the improvement under paragraph (d) of this section and depreciated the improvement in accordance with section 168(f)(6) as nonresidential real property under section 168(e). In Year 7, X determined that the structural improvement made in Year 5 qualified under section 168(e)(8) as qualified retail improvement property and, therefore, is 15-year property under section 168(e). In Year 7, X changed its method of accounting to use a 15-year recovery period for the improvement. Under the additional rule of paragraph (e)(5)(i) of this section, in Year 7, X must treat the improvement as a unit of property separate from the building.

Example 18. Additional rules; change in subsequent year. In Year 1, X acquired and placed in service a building and parking lot for use in its retail operations. Under §1.263(a)-2T of the regulations, X capitalized the cost of the building and the parking lot and began depreciating the building and the parking lot as nonresidential real property under section 168(e). In Year 3, X completed a cost segregation study under which it properly determined that the parking lot qualifies as 15-year property under section 168(e). In Year 3, X changed its method of accounting to use a 15-year recovery period and the 150-percent declining balance method of depreciation for the parking lot. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 3, X must treat the parking lot as a unit of property separate from the building.

Example 19. Additional rules; change in subsequent year. In Year 1, X acquired and placed in service a building for use in its manufacturing business. X capitalized the costs allocable to the building’s wiring separately from the building and depreciated the wiring as 7-year property under section 168(e). X capitalized the cost of the building and all other structural components of the building and began depreciating them as nonresidential real property under section 168(e). In Year 3, X completed a cost segregation study under which it properly determined that the wiring is a structural component of the building and, therefore, should have been depreciated as nonresidential real property. In Year 3, X changed its method of accounting to treat the wiring as nonresidential real property. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 3, X must change the unit of property for the wiring in a manner that is consistent with the change in treatment for depreciation purposes. Therefore, X must change the unit of property for the wiring to treat it as a structural component of the building, and as part of the building unit of property, in accordance with paragraph (e)(2)(ii) of this section.

(f) Special rules for determining improvement costs—(1) Improvements to leased property—(i) In general. This paragraph (f)(1) provides the exclusive rules for determining whether amounts paid by a lessee are for the improvement to a unit of leased property and must be capitalized. In the case of a leased building or a leased portion of a building, an amount results in an improvement to a unit of leased property if it results in an improvement to any of the properties designated under paragraph (e)(2)(ii) of this section (for lessee improvements) or under paragraph (e)(2)(v) of this section (for lessee improvements except as provided in paragraph (f)(2)(v)B) of this section). Section 1.263(a)-4 of the regulations does not apply to amounts paid for improvements to units of leased property or to amounts paid for the acquisition or production of leasehold improvement property.

(11) Lessee improvements—(A) Requirement to capitalize. A taxpayer lessee must capitalize the aggregate of related amounts that it pays to improve (as defined under paragraph (d) of this section) a unit of leased property except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement or where the improvement constitutes a substitute for rent. See §1.61–8(c) for the treatment of lessee expenditures that constitute a substitute for rent. A taxpayer lessee
must also capitalize the aggregate of related amounts that a lessor pays to improve (as defined under paragraph (d) of this section) a unit of leased property if the lessee is the owner of the improvement except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. An amount paid for a lessee improvement under this paragraph (f)(1)(ii)(A) is treated as an amount paid to acquire or produce a unit of real or personal property under §1.263(a)-2T(d)(1) of the regulations. See paragraph (e)(2)(v) of this section for the treatment of expenditures by lessees. See paragraphs (e)(3)(iv) of this section for the unit of property for leased real or personal property other than a building.

(B) Unit of property for lessee improvements. An amount capitalized as a lessee improvement under paragraph (f)(1)(ii)(A) of this section comprises a unit of property separate from the leased property being improved. However, an amount that a lessee pays to improve (as defined under paragraph (d) of this section) a lessee improvement under paragraph (f)(1)(ii)(A) is not a unit of property separate from such lessee improvement.

(iii) Lessor improvements—(A) Requirement to capitalize. A taxpayer lessor must capitalize the aggregate of related amounts that the lessee pays to improve a unit of property (as defined in paragraph (d) of this section) where the lessee’s improvement constitutes a substitute for rent. See §1.61-8(c) for treatment of expenditures by lessees that constitute a substitute for rent. Amounts capitalized by the lessor under this paragraph (f)(1)(iii)(A) may not be capitalized by the lessee. See paragraphs (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

(B) Unit of property for lessor improvements. An amount capitalized as a lessor improvement under paragraph (f)(1)(iii)(A) of this section is not a unit of property separate from the unit of property improved. See paragraph (e)(4) of this section.

(iv) Examples. The application of this paragraph (f)(1) is illustrated by the following examples, in which it is assumed that section 110 does not apply to the lessee.

Example 1. Lessee improvements; additions to building. (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. The leased building consists of the building structure under paragraph (e)(2)(i)(A) of this section and various building systems under paragraph (e)(2)(ii)(B) of this section, including a plumbing system, an electrical system, and an HVAC system. Under the terms of the lease, T is permitted to improve the building at its own expense. Under paragraph (e)(2)(v)(A) of this section, because T leases the entire building, T must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B)(1) of this section, an amount is paid for an improvement to the entire leased building if it results in an improvement to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(1) and (e)(2)(ii) of this section, if T pays an amount that improves the building structure, the plumbing system, the electrical system, or the HVAC system, then T must treat this amount as an improvement to the entire leased building.

(ii) In Year 2, T pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that this amount results in a betterment (as defined under paragraph (h) of this section) to T’s leased building structure and does not affect any building systems. Accordingly, the amount that T pays for the building extension results in an improvement to the leased building structure, and thus, under paragraph (e)(2)(v)(B)(1) of this section, is treated as an improvement to the entire leased building under paragraph (d) of this section. Because T, the lessee, paid an amount to improve a unit of leased property, T is required to capitalize the amount paid for the building extension under paragraph (f)(1)(iii)(A) of this section. In addition, paragraph (f)(1)(iii)(A) of this section requires T to treat the amount paid for the improvement as the acquisition or production of a unit of property (leasehold improvement property) under §1.263(a)-2T(d)(1). Moreover, under paragraph (f)(1)(iii)(B) of this section, the building extension is a unit of property.
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separate from the unit of leased property (the building and its structural components). In Year 5, T pays an amount to add a larger door to the building extension that it constructed in Year 2 in order to accommodate the loading of larger products into the warehouse space. Assume that the amount paid to add the larger door results in a betterment under paragraph (h) of this section to the building structure extension, the unit of property under paragraph (f)(1)(ii)(B) of this section. As a result, T must capitalize the amounts paid to add the larger door as an improvement to T’s unit of property (the building extension) under paragraph (d) of this section. In addition, because the amount that T paid to add the larger door is for an improvement to the building extension (a lessee improvement under paragraph (f)(1)(ii)(A)), the larger door is not a unit of property separate from the unit of property improved. See paragraphs (e)(4) and (f)(1)(ii)(B) of this section.

Example 2. Lessee improvements; additions to certain structural components of buildings. (i) Assume the same facts as Example 1 except that in Year 2, T also pays an amount to construct an extension of the HVAC system into the building extension. Assume that the extension is a betterment under paragraph (h) of this section to the leased HVAC system (a building system under paragraph (e)(2)(i)(B)(1) of this section). Accordingly, the amount that T pays for the extension of the HVAC system results in an improvement to a leased building system, the HVAC system, and thus, under paragraph (e)(2)(ii)(B)(1) of this section, is treated as an improvement to the entire leased building under paragraph (d) of this section. Because T, the lessee, incurs costs to improve a unit of leased property, T is required to capitalize the costs of the improvement under paragraph (f)(1)(ii)(A) of this section. Under paragraph (f)(1)(ii)(B), the extension to the leased HVAC system is a unit of property separate from the unit of leased property (the leased building and its structural components). In addition, under paragraph (f)(1)(ii)(A) of this section, T must treat the amount paid for the HVAC extension as the acquisition (h) and production of a unit of property under §1.263(a)–2T(d)(1).

(ii) In Year 5, T pays an amount to add an additional chiller to the portion of the HVAC system that it constructed in Year 2 in order to accommodate the climate control requirements for new product offerings. Assume that the amount paid for the chiller results in a betterment under paragraph (h) of this section to the HVAC system extension, the unit of property under paragraph (f)(1)(ii)(B) of this section. Accordingly, T must capitalize the amount paid to add the chiller as an improvement to T’s unit of property (the HVAC system extension) under paragraph (d) of this section. In addition, because the amount that T paid to add the chiller is for an improvement to the HVAC system extension (a lessee improvement under paragraph (f)(1)(ii)(A) of this section), the chiller is not a unit of property separate from the unit of property improved. See paragraphs (f)(1)(ii)(B) and (e)(4) of this section.

Example 3. Lessor Improvements; additions to building. (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T intends to use to construct an extension to the retail sales facility for additional warehouse space. Assume that the amount paid for any improvement to the building does not exceed the construction allowance and that L is treated as the owner of any improvement to the building. Under paragraph (e)(2)(i) of this section, L must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount paid is for an improvement to the building if it results in an improvement to the building structure or to any building system. In Year 2, T uses L’s construction allowance to construct an extension to the leased building to provide additional warehouse space in the building. Assume that the extension is a betterment (as defined under paragraph (h) of this section) to the building structure, and therefore, the amount paid for the extension results in an improvement to the building structure under paragraph (d) of this section. Under paragraph (f)(1)(ii)(A) of this section, L, the lessor and owner of the improvement, must capitalize the amounts paid for T to construct the extension to the retail sales facility. T is not permitted to capitalize the amounts paid for the lessor-owned improvement. Finally, under paragraph (f)(1)(iii)(B) of this section, the extension to L’s building is not a unit of property separate from the building and its structural components.

Example 4. Lessee property; personal property added to leased building. T is a retailer of consumer products. T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T uses to acquire and construct partitions for fitting rooms, counters, and shelving. Assume that each partition, counter, and shelving unit is a unit of property under paragraph (e)(3) of this section. Assume that for federal income tax purposes T is treated as the owner of any personal property that it acquires or constructs with the construction allowance and that the amounts paid for acquisition or construction of any personal property used in the leased property do not constitute a substitute for rent. T’s expenditures for the partitions, counters, and shelving are not improvements to the leased property under
Example 5. Lessor property; buildings on leased property. L is the owner of a parcel of unimproved real property that L leases to T. Pursuant to the lease, L provides a construction allowance to T of $500,000, which T agrees to use to construct a building costing not more than $500,000 on the leased real property and to lease the building from L after it is constructed. Assume that for Federal income tax purposes, L is treated as the owner of the building that T will construct. T uses the $500,000 to construct the building as required under the lease. The building consists of the building structure and the following building systems: (1) a plumbing system; (2) an electrical system; and (3) an HVAC system. Because L provides a construction allowance to T to construct a building, the total cost of the building equals $500,000, and L is treated as the owner of the building under paragraph (f)(1)(iii)(A) of this section. L must capitalize the amounts that it pays indirectly to acquire and produce the building under §1.263(a)–2T(d)(1). Under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. Under paragraph (f)(1)(iii)(A) of this section, T, the lessee, may not capitalize the amounts paid (with the construction allowance received from L) for construction of the building.

Example 6. Lessee contribution to construction costs. Assume the same facts as in Example 5, except T spends $600,000 to construct the building. T uses the $500,000 construction allowance provided by L plus $100,000 of its own funds to construct the building that L will own pursuant to the lease. Also assume that the additional $100,000 that T incurs is not a substitute for rent. For the reasons discussed in Example 5, L must capitalize all the direct costs of the building, under paragraph (e)(2)(i) of this section, but rather constitute amounts paid to acquire or produce separate units of personal property under §1.263(a)–2T.

(2) Compliance with regulatory requirements. For purposes of this section, a Federal, state, or local regulator’s requirement that a taxpayer perform certain repairs or maintenance on a unit of property to continue operating the property is not relevant in determining whether the amount paid improves the unit of property.

(3) Certain costs incurred during an improvement—(1) In general. A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair or component removal costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Therefore, indirect costs that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement.

(ii) Exception for individuals’ residences. A taxpayer who is an individual may capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to units of property not used in the taxpayer’s trade or business or for the production of income if the amounts are paid as part of a remodeling of the taxpayer’s residence.

(4) Aggregate of related amounts. For purposes of paragraph (d) of this section, the aggregate of related amounts paid to improve a unit of property may be incurred over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed and whether the costs are incurred by reason of a single improvement or directly benefit a single improvement.

(g) Safe harbor for routine maintenance on property other than buildings—(1) In general. An amount paid for routine maintenance performed on a unit of property other than a building or a structural component of a building is deemed not to improve that unit of property. Routine maintenance is the recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts.
of the unit of property with comparable and commercially available and reasonable replacement parts. The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life (as defined in paragraph (g)(4) of this section) of the unit of property. Among the factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers’ recommendations, the taxpayer’s experience, and the taxpayer’s treatment of the activity on its applicable financial statement (as defined in paragraph (b)(4) of this section). With respect to a taxpayer that is a lessor of a unit of property, the taxpayer’s use of the unit of property includes the lessee’s use of the unit of property.

(2) Rotable and temporary spare parts. Except as provided in paragraph (g)(3) of this section, for purposes of paragraph (g)(1) of this section, amounts paid for routine maintenance include routine maintenance performed on (and with regard to) rotatable and temporary spare parts. But see §1.162–3T(a)(3), which provides generally that rotatable and temporary spare parts are used or consumed by the taxpayer in the taxable year in which the taxpayer disposes of the parts.

(3) Exceptions. Routine maintenance does not include the following:

(i) Amounts paid for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under §1.165–7).

(ii) Amounts paid for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss resulting from the sale or exchange of the component.

(iii) Amounts paid for the repair of damage to a unit of property for which the taxpayer has taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165.

(iv) Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.

(v) Amounts paid for repairs, maintenance, or improvement of rotatable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotatable and temporary spare parts under §1.162–3T(e).

(4) Class life. The class life of a unit of property is the recovery period prescribed for the property under sections 168(g)(2) and (3) for purposes of the alternative depreciation system, regardless of whether the property is depreciated under section 168(g). For purposes of determining class life under this section, section 168(g)(3)(A) (relating to tax-exempt use property subject to lease) does not apply. If the unit of property is comprised of more than one component with different class lives, then the class life of the unit of property is deemed to be the same as the component with the longest class life.

(5) Examples. The following examples illustrate the rules of this paragraph (g). Unless otherwise stated, assume that X has not applied the optional method of accounting for rotatable and temporary spare parts under §1.162–3T(e):
Performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in X's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available and reasonable replacement part. After the ESVs, the engines are returned to X to be reinstalled on another aircraft or stored for later installation. Assume that the unit of property for X's aircraft is the entire aircraft, including the aircraft engines, and that the class life for X's aircraft is 12 years. Assume that none of the exceptions set out in paragraph (g)(3) of this section applies to the costs of performing the ESVs.

(ii) Because the ESVs involve the recurring activities that X expects to perform as a result of its use of the aircraft to keep the aircraft in ordinarily efficient operating condition, and consist of maintenance activities that X expects to perform more than once during the 12 year class life of the aircraft, X's ESVs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for this ESV, even though performed after the class life of the aircraft, the ESVs fall within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the ESVs for the four additional engines are deemed not required to be capitalized under paragraph (d) of this section.

Example 2. Routine maintenance after class life. Assume the same facts as in Example 1, except that in year 15, X pays amounts to perform an ESV on one of the original aircraft engines, after the end of the class life of the aircraft. Because this ESV involves the same routine maintenance activities that were performed on aircraft engines in Example 1, this ESV also is within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for this ESV, even though performed after the class life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

Example 3. Routine maintenance on rotatable spare parts. (i) Assume the same facts as in Example 1, except that in addition to the four engines purchased as part of the aircraft, X separately purchases four additional new engines that X intends to use in its aircraft fleet to avoid operational downtime when ESVs are required to be performed on the engines previously installed on an aircraft. Later in year 1, X installs these four engines on an aircraft in its fleet. In year 5, X performs the first ESVs on these four engines. Assume that these ESVs involve the same routine maintenance activities that were performed on the engines in Example 1, and that none of the exceptions set out in paragraph (g)(3) of this section apply to these ESVs. After the ESVs were performed, these engines were reinstalled on other aircraft or stored for later installation. (ii) The majority of X's costs do not qualify under the routine maintenance safe harbor in paragraph (g) of this section because the costs were incurred primarily as a result of the prior owner's use of the property and not X's use. X acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amounts paid for the scheduled maintenance resulted from the prior owner's, and not the taxpayer's, use of the property and must be capitalized if those amounts result in a betterment under paragraph (h) of this section, including the...
amelioration of a material condition or defect, or otherwise result in an improvement under paragraph (d) of this section. See also section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 5. Recurring activities that X expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 12 year class lives of the containers, X's lining replacement costs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts that X paid for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d) of this section. See also section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 6. Routine maintenance; replacement of substantial structural part. X is in the business of converting raw materials into the finished product. The lining is a substantial structural part of the container, and comprises 60 percent of the total physical structure of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of 12 years. At the time that X placed the container into service, X was aware that approximately every three years, X would be required to replace the lining in the container with comparable and commercially available and reasonable replacement materials. At the end of that period, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. In Year 1, X acquired 10 new containers and placed them into service. In Year 4, Year 7, Year 9, and Year 12, X pays amounts to replace the containers' linings with comparable and commercially available and reasonable replacement parts. Assume that none of the exceptions set out in paragraph (g)(3) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that X expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 12 year class lives of the containers, X's lining replacement costs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts that X paid for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d) of this section. See also section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 7. Routine maintenance once during class life. X is a Class I railroad that owns a fleet of freight cars. Assume that a freight car, including all its components, is a unit of property and has a class life of 14 years. At the time that X places a freight car into service, X expects to perform cyclical reconditioning to the car every 8 to 10 years in order to keep the freight car in ordinarily efficient operating condition. During this reconditioning, X pays amounts to disassemble, inspect, and recondition or replace components of the freight car with comparable and commercially available and reasonable replacement parts. Ten years after X places the freight car in service, X pays amounts to perform a cyclical reconditioning on the car. Because X expects to perform the reconditioning only once during the 14 year class life of the freight car, the amounts X pays for the reconditioning do not qualify for the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, X must capitalize the amounts paid for the reconditioning of the freight car if these amounts result in an improvement under paragraph (d) of this section.

Example 8. Routine maintenance on nonrotatable part. X is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. At the time that X places its towboats into service, X is aware that approximately every three to four years, X will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This
maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available and reasonable replacement parts. Assume the towboat engines are not rotatable spare parts under §1.162-3T(c)(2). In Year 1, X acquired a new towboat, including its two engines, and placed the towboat into service. In Year 5, X pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (g)(3) of this section apply to the scheduled maintenance costs. Because the scheduled maintenance involves recurring activities that X expects to perform more than once during the 18 year class life of the towboat, the maintenance results from X’s use of the towboat and the maintenance is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on X’s towboat is within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

Example 9. Routine maintenance with betterments. Assume the same facts as Example 8, except that in Year 9, X’s towboat engines are due for another scheduled maintenance visit. At this time, X decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in Year 9, X pays amounts to perform many of the same activities that it would perform during the typical scheduled maintenance activities such as cleaning, inspecting, reconditioning, and replacing minor parts, but at the same time, X incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity of the boats when X placed them in service. Both the scheduled maintenance procedures and the replacement of parts with new and upgraded parts are necessary to increase the horsepower of the engines and the towing capacity of the boat. Thus, the work done on the engines encompasses more than the recurring activities that X expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. In addition, under paragraph (f)(3)(i) of this section, the scheduled maintenance procedures directly benefit the upgrades. Therefore, the amounts that X paid in Year 9 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (g) of this section. These amounts must be capitalized if they result in a betterment under paragraph (h) of this section, including a material increase in the capacity of the towboat, or otherwise result in an improvement under paragraph (d) of this section.

Example 10. Exceptions to routine maintenance. X owns and operates a farming and cattle ranch with an irrigation system that provides water for crops. Assume that each canal in the irrigation system is a single unit of property and has a class life of 20 years. At the time X placed the canals into service, X expected to have to perform major maintenance on the canals every 3 years to keep the canals in their ordinarily efficient operating condition. This maintenance includes draining the canals, and then cleaning, inspecting, repairing, reconditioning, and replacing parts of the canals with comparable and commercially available and reasonable replacement parts. Although the work performed on X’s canals was similar to the activities that X expected to perform, but did not perform, every three years, the costs of these activities do not fall within the routine maintenance safe harbor. Specifically, under paragraph (g)(3)(iv) of this section, routine maintenance does not include activities that return a unit of property to its former ordinary efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use. Accordingly, amounts that X pays for work performed on the canals in Year 6 must be capitalized if they result in improvements under paragraph (d) of this section (for example, restorations under paragraph (i) of this section).

(b) Capitalization of betterments—(1) In general. A taxpayer must capitalize amounts paid that result in the betterment of a unit of property. An amount paid results in the betterment of a unit of property only if it—

(i) Ameliorates a material condition or defect that either existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property, whether or
not the taxpayer was aware of the condition or defect at the time of acquisition or production;

(ii) Results in a material addition (including a physical enlargement, expansion, or extension) to the unit of property; or

(iii) Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

(2) Betterments to buildings. In the case of a building, an amount results in a betterment to the unit of property if it results in a betterment to any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section.

(3) Application of general rule—(i) Facts and circumstances. To determine whether an amount paid results in a betterment described in paragraph (h)(1) of this section, it is appropriate to consider all the facts and circumstances including, but not limited to, the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer’s treatment of the expenditure on its applicable financial statement (as described in paragraph (b)(4) of this section).

(ii) Unavailability of replacement parts. If a taxpayer needs to replace part of a unit of property that cannot practically be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved, but comparable, part does not, by itself, result in a betterment to the unit of property.

(iii) Appropriate comparison—(A) In general. In cases in which a particular event necessitates an expenditure, the determination of whether an expenditure results in a betterment of the unit of property is made by comparing the condition of the property immediately prior to the expenditure with the condition of the property immediately prior to the circumstances necessitating the expenditure.

(B) Normal wear and tear. If the expenditure is made to correct the effects of normal wear and tear to the unit of property (including the amelioration of a condition or defect that existed prior to the taxpayer’s acquisition of the unit of property resulting from normal wear and tear), the condition of the property immediately prior to the circumstance necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (whether the amounts paid were for maintenance or improvements) or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer.

(C) Particular event. If the expenditure is made as a result of a particular event, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to the particular event.

(4) Examples. The following examples illustrate the application of this paragraph (h) only and do not address whether capitalization is required under another provision of this section or another provision of the Internal Revenue Code (for example, section 263A):

Example 1. Amelioration of pre-existing material condition or defect. In Year 1, X purchases a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked, causing soil contamination. X is not aware of the contamination at the time of purchase. In Year 2, X discovers the contamination and incurs costs to remediate the soil. The remediation costs result in a betterment to the land under paragraph (h)(1)(i) of this section because X incurred the costs to ameliorate a material condition or defect that existed prior to X’s acquisition of the land.

Example 2. Not amelioration of pre-existing condition or defect. X owns a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. X determines that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X pays an amount to remove the asbestos-containing insulation from the building structure and replace it with new insulation that is safer to employees, but no more efficient or effective than the asbestos insulation.
Under paragraph (e)(2)(i) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Although asbestos is determined to be unsafe under certain circumstances, the asbestos is not a pre-existing or material defect of the building structure under paragraph (h)(1)(i) of this section. In addition, the removal and replacement of the asbestos does not result in a material addition to the building structure under paragraph (h)(1)(ii) of this section or result in a material increase in capacity, productivity, efficiency, or quality of the building structure or the output of the building structure under paragraph (h)(1)(iii) of this section. Therefore, the amount paid to remove and replace the asbestos insulation does not result in a betterment to the building structure under paragraph (h) of this section.

Example 3. Not amelioration of pre-existing material condition or defect. (i) In January, Year 1, X purchased a used machine for use in its manufacturing operations. Assume that the machine is a unit of property and has a class life of 10 years. X placed the machine in service in January, Year 1 and at that time expected to perform manufacturer recommended scheduled maintenance on the machine every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. The scheduled maintenance does not result in any material additions or material increase in capacity, productivity, efficiency, strength, or quality of the machine or the output of the machine. At the time X purchased the machine, it was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, X pays an amount to perform the manufacturer recommended scheduled maintenance on the machine to keep the machine in its ordinarily efficient operating condition.

(ii) The amount that X pays does not qualify under the routine maintenance safe harbor in paragraph (g) of this section because the cost primarily results from the prior owner’s use of the property and not the taxpayer’s use. X acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amount that X pays for the scheduled maintenance results from the prior owner’s use of the property and ameliorates conditions or defects that existed prior to X’s ownership of the machine. Nevertheless, considering the facts and circumstances under paragraph (h)(2)(i) of this section, including the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (h)(1)(i) of this section, result in a material addition to the machine under paragraph (h)(1)(ii) of this section, or result in a material increase in the capacity, productivity, efficiency, strength, or quality of the machine or the output of the machine under paragraph (h)(1)(iii) of this section. Therefore, X is not required to capitalize the amount paid for the scheduled maintenance as a betterment to the machine under this paragraph (h).

Example 4. Not amelioration of pre-existing material condition or defect. X purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, X is required to monitor routinely the air quality in the ice skating rink. One week after X places the machine into service, during a routine air quality check, X discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, X pays an amount to inspect and retune the machine, which includes replacing minor components of the engine, which had worn out prior to X’s acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (g) of this section does not apply to the amounts paid because the activities performed do more than return the machine to the condition that existed at the time X placed it in service. The amount that X pays to inspect, retune, and replace minor components of the machine ameliorates a condition or defect that existed prior to X’s acquisition of the equipment. Nevertheless, considering the facts and circumstances under paragraph (h)(3)(i) of this section, including the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (h)(1)(i) of this section, result in a material addition to the machine under paragraph (h)(1)(ii) of this section, or result in a material increase in the capacity, productivity, efficiency, strength, or quality of the machine or the output of the machine under paragraph (h)(1)(iii) of this section. Therefore, X is not required to capitalize the amount paid to inspect, retune, and replace minor components of the machine as a betterment under this paragraph (h).

Example 5. Amelioration of material condition or defect. (i) X acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functions as an assisted living facility. However, at the time of the purchase, X is aware that the building is in a condition that is below the standards that X requires for facilities used in its business. Immediately after the acquisition and during the following two years, while X continues to
use the building as an assisted living facility, X pays amounts for repairs, maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which X’s facilities are known. The work on X’s building includes repairing damaged drywall, repainting, re-wallpapering, replacing windows, repairing and replacing roofing materials. The work also involves the replacement of section 1245 property including window treatments, furniture, and cabinets. On its applicable financial statements, X capitalizes the costs of the repairs and maintenance to the building. The work that X performs affects only the building structure under paragraph (e)(2)(i)(A) of this section and does not affect any of the building systems described in paragraph (e)(2)(i)(B) of this section. Assume that each section 1245 property is a separate unit of property.

(ii) Under paragraph (e)(2)(i)(A) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditures, the effect of the expenditures on the building structure, and the treatment of the expenditures in X’s applicable financial statements, the amounts that X paid for repairs and maintenance to the building structure comprises a betterment to the building structure under paragraph (h)(1)(i) of this section because the amounts ameliorate material conditions or defects that existed prior to X’s acquisition of the building. Therefore, in accordance with paragraph (e)(2)(i)(A) of this section, X must treat the amounts paid for the betterment to the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(1) of this section. Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property, including each window treatment, each item of furniture, and each cabinet, in accordance with §1.263(a)-2T(d)(1).

Example 6. Not a betterment; building refresh. (i) X owns a nationwide chain of retail stores that sell a wide variety of items. To remain competitive in the industry and increase customer traffic and sales volume, X periodically refreshes the appearance and layout of its stores. The work that X performs to refresh a store consists of cosmetic and layout changes to the store’s interiors and general repairs and maintenance to the store building to make the store more attractive and the merchandise more accessible to customers. The work to each store building consists of replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing vinyl flooring throughout the store, and power washing building exteriors. The display tables and the racks all constitute section 1245 property. X pays amounts to refresh 50 stores during the taxable year. In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period. Assume that each section 1245 property within each store is a separate unit of property. Finally, assume that the work does not ameliorate any material conditions or defects that existed when X acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraph (e)(2)(i)(B) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditures, the physical nature of the work performed, the effect of the expenditure on buildings’ structures and systems, and the treatment of the work on X’s applicable financial statements, the amounts paid for the refresh of each building do not result in material increases in capacity, productivity, efficiency, strength, or quality of the buildings’ structures or any building systems as compared to the condition of the buildings’ structures and systems after the previous refresh. Rather, the work performed keeps X’s store buildings’ structures and buildings’ systems in the ordinary efficient operating condition that is necessary for X to continue to attract customers to its stores. Therefore, X is not required to treat the amounts paid for the refresh of its store buildings’ structures and buildings’ systems as betterments under paragraph (h)(1)(i)(ii) of this section. However, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with §1.263(a)-2T(d)(1).

Example 7. Building refresh; limited improvement. Assume the same facts as Example 6 except, in the course of X’s refresh of its stores, X pays amounts to remove and replace the bathroom fixtures (that is, the toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in X’s retail buildings in order to update the restroom facilities. As part of the update of the restrooms, X also pays amounts to replace the floor and wall tiles that were removed or damaged in the installation of the new plumbing fixtures. Under paragraph (e)(2)(i)(B)
of this section, if any of the amounts paid result in betterments to the building structure or any building system, X must treat the amounts as an improvement to the building. Under paragraph (e)(2)(ii)(B)(2) of this section, the plumbing system in each of X’s store buildings, including the plumbing fixtures, is a building system. X must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a betterment because they result in a material increase in the quality of each plumbing system under paragraph (h)(1)(iii) of this section. Under paragraph (f)(3) of this section, X is required to capitalize all the indirect costs that directly benefit or are incurred by reason of the betterment, or improvement, to each plumbing system. Because the costs to remove the old plumbing fixtures and to remove and replace the bathroom tiles directly benefit and are incurred by reason of the improvement to the plumbing system, these costs must also be capitalized under paragraph (f)(3) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid for a betterment to each plumbing system as an improvement to X’s retail building to which the costs relate, and must capitalize the amounts under paragraph (d)(1) of this section. However, X is not required under paragraph (f)(3) of this section to capitalize the costs described in Example 6 to refresh the appearance and layout of its stores because those costs do not directly benefit and are not incurred by reason of the improvements to the stores’ plumbing systems. Thus, X is not required to capitalize under paragraphs (f)(3) of this section any costs specified in Example 6 for the reconfiguration, cosmetic changes, repairs, and maintenance to the other parts of X’s store buildings.

Example 6. Betterment; building remodel. (1) Assume the same facts as Example 6, but assume that the work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel to X’s store buildings. In addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities performed in Example 6, X performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume. First, X pays amounts to upgrade the buildings’ structures as defined under (e)(2)(ii)(A). This work includes removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores, replacing ceilings with acoustical tiles to reduce noise and create a more pleasant shopping environment, rebuilding the interior and exterior facades around the main doors to create a more appealing entrance, replacing conventional doors with automatic doors, and replacing carpet with ceramic flooring of different textures and styles to delineate departments and direct customer traffic. Second, X pays amounts for work on the electrical systems, which are building systems under paragraph (e)(2)(ii)(B)(3) of this section. Specifically, X upgrades the wiring in the buildings so that X can add video monitors and an expanded electronics department. X also removes and replaces the recessed lighting throughout the buildings with more efficient and brighter lighting. The work performed on the buildings’ structures and the electrical systems includes the removal and replacement of both section 1250 and section 1245 property. In its applicable financial statement, X capitalizes all the costs incurred over a 10-year period. Upon completion of this period, X anticipates that it will have to remodel the store buildings again.

(ii) Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in a betterment to the building structure or any building system, X must treat those amounts as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(1)(iii) of this section, including the purpose of the expenditure, the physical nature of the work performed, the effect of the work on the buildings’ structures and buildings’ systems, and the treatment of the work on X’s applicable financial statements, the amounts that X pays for the remodeling of its stores result in betterments to the buildings’ structures and electrical systems under paragraph (b) of this section. Specifically, amounts paid to upgrade the wiring and to remove and replace the recess lighting throughout the stores materially increase the productivity, efficiency, and quality of X’s stores’ electrical systems under paragraph (h)(1)(iii) of this section. Also, the amounts paid to remove and rebuild walls, to replace ceilings, to rebuild facades, to replace doors, and to replace flooring materially increase the productivity, efficiency, and quality of X’s store buildings’ structures under paragraph (h)(1)(iii) of this section. In addition, the amounts paid for the refresh of the store buildings described in Example 6 must be capitalized under paragraph (f)(3)(i) of this section because these expenditures directly benefit or were incurred by reason of the improvements to X’s store buildings’ structures and electrical systems. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the costs of improving the buildings’ structures and systems, including the costs to refresh, as improvements to X’s retail buildings and must capitalize the amounts paid for these improvements under paragraph (d)(1) of this section. Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with §1.263(a)-2T(d)(1).

Example 9. Not betterment; relocation and reinstallation of personal property. In Year 1, X purchases new cash registers for use in its
retail store located in leased space in a shopping mall. Assume that each cash register is a unit of property as determined under paragraph (e)(3) of this section. In Year 1, X capitalizes the costs of acquiring and installing the new cash registers under §1.263(a)-2T(d)(1). In Year 3, X's lease expires and X decides to relocate its retail store to a different building in the same building system. To move the cash registers from their current location to their new location, X incurs $5,000 to move the cash registers and $1,000 to reinstall them. The cash registers are used for the same purposes and in the same manner that they were used in the former location. The amounts that X pays to move and reinstall the cash registers into its new store do not result in a betterment to the cash registers under paragraph (h) of this section.

Example 10. Betterment; relocation and reinstallation of manufacturing equipment. X operates a manufacturing facility in Building A, which contains various machines that X uses in its manufacturing business. X decides to expand part of its operations by relocating a machine to Building B to reconfigure the machine with additional components. Assume that the machine is a single unit of property under paragraph (e)(3) of this section. X pays amounts to disassemble the machine, move to the new location, and to reinstall the machine in a new configuration with additional components. Assume that the reinstallation, including the reconfiguration and the addition of components, results in an increase in capacity of the machine, and therefore results in a betterment to the machine under paragraph (h)(3)(iii) of this section. Accordingly, X must capitalize the costs of reinstalling the machine as an improvement to the machine under paragraph (d)(1) of this section.

Example 11. Betterment; regulatory requirement. X owns a hotel that includes five feet high unreinforced terra cotta and concrete parapets with overhanging cornices around the entire roof perimeter. The parapets and cornices are in good condition. In Year 1, City passes an ordinance setting higher safety standards for parapets and cornices because of the hazardous conditions caused by earthquakes. To comply with the ordinance, X pays an amount to remove the old parapets and cornices and replace them with new ones made of glass fiber reinforced concrete, which makes them lighter and stronger than the original components. They are attached to the hotel using welded connections instead of wire supports, making them more resistant to damage from lateral movement. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The parapets and cornices are part of the building structure as defined in paragraph (e)(2)(i)(A) of this section. The event necessitating the expenditure was the City ordinance. Prior to the ordinance, the old parapets and cornices were in good condition, but were determined by City to create a potential hazard. After the expenditure, the new parapets and cornices materially increased the structural soundness (that is, the strength) of the hotel structure. X must treat the amount paid to remove and replace the parapets and cornices as an improvement because it results in a betterment to the building structure under paragraph (h)(1)(iii) of this section. Therefore, in accordance with paragraph (e)(2)(i) of this section, X must treat the amount paid for the betterment to the building structure as an improvement to the hotel building and must capitalize the amount paid under paragraph (d)(1) of this section. City's requirement that X correct the potential hazard to continue operating the hotel is not relevant in determining whether the amount paid improved the hotel. See paragraph (f)(2) of this section.

Example 12. Not a betterment; regulatory requirement. X owns a meat processing plant. X discovers that oil is seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advise X that it must correct the seepage problem or shut down its plant. To correct the problem, X pays an amount to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. X is not required to treat the amount paid as a betterment under paragraph (h) of this section because it does not result in a material addition or material increase in capacity, productivity, efficiency, strength or quality of the building structure or its output compared to the condition of the structure prior to the seepage of the oil. The federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improved the plant. See paragraph (f)(2) of this section.

Example 13. Not a betterment; replacement with same part. X owns a small retail shop. X discovers that oil is seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advise X that it must correct the seepage problem or shut down its plant. To correct the problem, X pays an amount to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. X is not required to treat the amount paid as a betterment under paragraph (h) of this section because it does not result in a material addition or material increase in capacity, productivity, efficiency, strength or quality of the building structure or its output compared to the condition of the structure prior to the seepage of the oil. The federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improved the plant. See paragraph (f)(2) of this section.
paragraph (e)(2)(i)(A) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The roof is part of the building structure under paragraph (e)(2)(i)(A) of this section. The event necessitating the expenditure was the storm. Prior to the storm, the building structure functioned for its intended use. X is not required to treat the amount paid to replace the shingles as a betterment under paragraph (h) of this section because it does not result in a material addition, or material increase in the capacity, productivity, efficiency, strength, or quality of the building structure or the output of the building structure compared to the condition of the building structure prior to the storm.

Example 14. Not a betterment; replacement with comparable part. Assume the same facts as in Example 13, except that wooden shingles are not available on the market. X pays a contractor to replace all the wooden shingles with comparable asphalt shingles. The amount that X pays to reshingle the roof with asphalt shingles does not result in a betterment to the shop building structure, even though the asphalt shingles may be stronger than the wooden shingles. Because the wooden shingles could not practicably be replaced with new wooden shingles, the replacement of the old shingles with comparable asphalt shingles does not, by itself, result in a betterment, and therefore, an improvement, to the shop building structure under this paragraph (h).

Example 15. Betterment; replacement with improved parts. Assume the same facts as in Example 14, except that, instead of replacing the wooden shingles with asphalt shingles, X pays a contractor to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating. The amount paid for these shingles results in a betterment to the shop building structure under paragraphs (h)(1)(iii) and (h)(3)(iii) of this section because it results in a material increase in the quality of the shop building structure as compared to the condition of the shop building structure prior to the storm. Therefore, in accordance with paragraph (e)(2)(i)(A), X must treat the amount paid for the betterment of the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(1) of this section.

Example 16. Material increase in capacity. X owns a factory building with a storage area on the second floor. X pays an amount to replace the columns and girders supporting the second floor to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. Under paragraph (e)(2)(i) of this section, if the amount results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The columns and girders are part of the building structure defined under paragraph (e)(2)(i)(A) of this section. X must treat the amount paid to replace the columns and girders as a betterment under paragraph (h)(1)(iii) of this section because it materially increases the load-carrying capacity of the building structure. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to this amount because the expenditure was not necessitated by a particular event. Therefore, in accordance with paragraph (e)(2)(i) of this section, X must treat the amount paid for betterment of the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(1) of this section.

Example 17. Material increase in capacity. X owns harbor facilities consisting of a slip for the loading and unloading of barges and a channel leading from the slip to the river. At the time of purchase, the channel was 150 feet wide, 1,000 feet long, and 10 feet deep. To allow for ingress and egress and for the unloading of its barges, X needs to deepen the channel to a depth of 22 feet. X pays a contractor to dredge the channel to the required depth. Assume the channel is the unit of property. X must capitalize as an improvement the amounts paid for the dredging because they result in a material increase in the capacity of the channel under paragraph (h)(1)(iii) of this section. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 18. Not a material increase in capacity. Assume the same facts as in Example 17, except that the channel was susceptible to siltation and, by the next taxable year, the channel depth had been reduced to 18 feet. X pays a contractor to redredge the channel to a depth of 22 feet. The event necessitating the expenditure was the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. X is not required to treat the amounts paid to redredge the channel as a betterment under paragraphs (h)(1)(i) or (h)(1)(iii) of this section because they do not result in a material addition to the unit of property or a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

Example 19. Not a material increase in capacity. X owns a building used in its trade or business. The first floor has a drop-ceiling. X pays an amount to remove the drop-ceiling and repaint the original ceiling. Under paragraph (e)(2)(i) of this section, if the amount
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paid results in a betterment to the building structure or any building system. X must treat the amount as an improvement to the building. The ceiling is part of the building structure as defined under paragraph (e)(2)(i)(A) of this section. X is not required to treat the amount paid to remove the drop-ceiling as a betterment because it did not result in a material addition under paragraph (h)(1)(ii) of this section or a material increase to the capacity, productivity, efficiency, strength, or quality of the building structure or output of the building structure under paragraph (h)(1)(iii) of this section. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

(i) Capitalization of restorations—(1) In general. A taxpayer must capitalize amounts paid to restore a unit of property, including amounts paid in making good the exhaustion for which an allowance is or has been made. An amount is paid to restore a unit of property only if it—

(i) Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165–7);

(ii) Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

(iii) Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165;

(iv) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

(v) Results in the rebuilding of the unit of property to a like-new condition after the end of its class life as defined in paragraph (g)(4) of this section (see paragraph (i)(3) of this section); or

(vi) Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property (see paragraph (i)(4) of this section).

(2) Restorations of buildings. In the case of a building, an amount is paid to restore the unit of property if it restores any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), (e)(2)(v)(B) of this section.

(3) Rebuild to like-new condition. For purposes of paragraph (i)(1)(v) of this section, a unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer’s original specifications.

(4) Replacement of a major component or a substantial structural part. To determine whether an amount is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property. A major component or substantial structural part includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property. However, the replacement of a minor component of the unit of property, even though such component may affect the function of the unit of property, will not generally, by itself, constitute a major component or substantial structural part.

(5) Examples. The following examples illustrate the application of this paragraph (i) only and do not address whether capitalization is required under another provision of this section or another provision of the Internal Revenue Code (for example, section 263A). Unless otherwise stated, assume that X has not properly deducted a loss for, nor taken into account the adjusted basis on a sale or exchange of, any unit of property, asset, or component of a unit of property that is replaced:

Example 1. Replacement of loss component. X owns a manufacturing building containing various types of manufacturing equipment.
X does a cost segregation study of the manufacturing building and properly determines that a walk-in freezer in the manufacturing building is section 1245 property as defined in section 1245(a)(3). The freezer is not part of the building structure under paragraph (e)(2)(i) of this section or the HVAC system, which is a separate building system under paragraph (i)(1)(iii) of this section. Several components of the walk-in freezer cease to function and X decides to replace them. X abandons the old freezer components and properly recognizes a loss from the abandonment of the components. X replaces the abandoned freezer components with new components and incurs costs to acquire and install the new components. Under paragraph (i)(1)(i) of this section, X must capitalize the amounts paid to acquire and install the new components for which it had properly deducted a loss.

Example 2. Replacement of sold component. Assume the same facts as in Example 1 except that X did not abandon the components, but instead sold them to another party and properly recognized a loss on the sale. Under paragraph (i)(1)(ii) of this section, X must capitalize the amounts paid to acquire and install the new freezer components because X replaced components for which it had properly taken into account the adjusted basis of the components in realizing a loss from the sale of the components.

Example 3. Restoration after casualty loss. X owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of $500,000. X deducts under section 165 a casualty loss in the amount of $50,000 and properly reduces its basis in the office building to $450,000. X hires a contractor to repair the damage to the building and pays the contractor $50,000 for the work. Under paragraph (i)(1)(i) of this section, X must capitalize the $50,000 amount paid to the contractor because X properly adjusted its basis in that amount as a result of a casualty loss under section 165.

Example 4. Restoration after casualty event. Assume the same facts as in Example 3, except that X receives insurance proceeds of $50,000 after the casualty to compensate for its loss. X cannot deduct a casualty loss under section 165 because its loss was compensated by insurance. However, X properly reduces its basis in the property by the amount of the insurance proceeds. Under paragraph (i)(1)(iii) of this section, X must capitalize the $50,000 amount paid to the contractor because X has properly taken a basis adjustment relating to a casualty event described in section 165.

Example 5. Restoration of property in a state of disrepair. X owns and operates a farm with several barns and outbuildings. X did not use or maintain one of the outbuildings on a regular basis, and the outbuilding fell into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because the building is not structurally sound. X decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding. Under paragraph (e)(2)(ii) of this section, if the amount paid to restore the building and amounts paid to shore up the walls and replace the siding are part of the building structure or any building system, X must treat the amount as an improvement to the building. The walls and siding are part of the building structure under paragraph (e)(2)(i)(A) of this section. Under paragraph (i)(1)(iv) of this section, X must treat the amount paid to shore up the walls and replace the siding as a restoration of the building structure because the amounts return the building structure to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 6. Rebuild of property to like-new condition before end of class life. X owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has a recovery period of 7 years under section 168(c) and a class life of 14 years. Every 8 to 10 years, X rebuilds its freight cars. Ten years after X places the freight car in service, X performs a rebuild, which includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. X modifies the car to upgrade various components to the latest engineering standards. The freight car essentially is stripped to the frame, with all of its subcomponents either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to rebuilt condition under the manufacturer’s specifications. Assume the freight car is the unit of property. X is not required to capitalize under paragraph (i)(1)(v) of this section the amounts paid to rebuild the freight car because, although the amounts paid restore the freight car to like-new condition, the amounts were not paid after the end of the class life of the freight car.

Example 7. Rebuild of property to like-new condition after end of class life. Assume the same facts as in Example 6, except that X rebuilds the freight car 15 years after X places it in service. Under paragraph (i)(1)(v) of this section, X must capitalize the amounts paid
to rebuild the freight car because the amounts paid restore the freight car to like-new condition after the end of the class life of the freight car.

Example 6. Placement of major component or substantial structural part; personal property. X is a common carrier that owns a fleet of petroleum hauling trucks. X pays amounts to replace the existing engine, cab, and tank. Assume the tractor of the truck (which includes the cab and the engine) is a single unit of property, and that the trailer (which contains the petroleum tank) is a separate unit of property. The new engine and cabin constitute parts or combinations of parts that comprise a major component or substantial structural part of X’s tractor. Therefore, the amounts paid for the replacement of those components must be capitalized under section 263(a), regardless of whether they are made at the same time as the repair of the broken taillight on the tractor. The repair of the broken taillight and the painting of the cab generally are deductible expenses under §1.162–4T. However, under paragraph (f)(3)(i) of this section, a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263A, regardless of whether they are made at the same time as an improvement. Under paragraph (f)(3)(i) of this section, X must capitalize the amounts paid to paint the cab as part of the improvement to the tractor because these amounts directly benefit and are incurred by reason of the restoration of the cab. Amounts paid to repair the broken taillight, however, are not incurred by reason of the restoration of the tractor, nor do the amounts paid directly benefit the tractor restoration, even though the repair was performed at the same time as the restoration. Thus, X is not required to capitalize the amounts paid to repair the broken taillight.

Example 7. Repair performed during a restoration. Assume the same facts as in Example 6, except that, at the same time the engine and cab of the tractor are replaced, X pays amounts to paint the cab of the tractor with its company logo and to fix a broken taillight on the tractor. The repair of the broken taillight and the painting of the cab constitute parts or combinations of parts that comprise a major component or substantial structural part of the trailer. Accordingly, the amounts paid for the replacement of the tank also must be capitalized under paragraph (i)(1)(vi) of this section.

Example 9. Repair performed during a restoration. Assume the same facts as in Example 8, except that, at the same time the engine and cab of the tractor are replaced, X pays amounts to paint the cab of the tractor with its company logo and to fix a broken taillight on the tractor. The repair of the broken taillight and the painting of the cab constitute parts or combinations of parts that comprise a major component or substantial structural part of the trailer. Accordingly, the amounts paid for the replacement of the tank also must be capitalized under paragraph (i)(1)(vi) of this section.

Example 10. Related amounts to replace major component or substantial structural part; personal property. (i) X owns a retail gasoline station, consisting of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline, and a canopy covering the gasoline pumps. Assume the new petroleum tank constitutes a part of or substantial structural part of the gasoline distribution system because the USTs are parts or combinations of parts that comprise a major component or substantial structural part of the gasoline distribution system. Moreover, under paragraph (f)(3) of this section, X must capitalize the aggregate of related amounts paid to improve the gasoline distribution system, including the amount paid to install the new USTs, even though the amounts were separately invoiced, paid to different parties, and incurred in different tax years.

Example 11. Not replacement of major component or substantial structural part; personal property. X owns a machine shop in which it makes dies used by manufacturers. In Year 1, ...
X purchased a drill press for use in its production process. In Year 3, X discovers that the power switch assembly, which controls the supply of electric power to the drill press, has become damaged and could not operate. To correct this problem, X paid amounts to replace the power switch assembly with comparable, commercially available and readily replaceable parts. Assume that the drill press is a unit of property under paragraph (e) of this section and the power switch assembly is a small component of the drill press that may be removed and installed with relative ease. Thus, the power switch assembly is not a major component or substantial structural part of X’s drill press under paragraph (i)(3) of this section. X is not required to capitalize the costs to replace the power switch assembly under paragraph (i)(1)(vi) of this section because the replacement, by itself, does not constitute the replacement of a part or a combination of parts that comprise a major component or substantial structural part of X’s drill press. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs that directly benefit or are incurred by reason of production activities.

Example 12. Replacement of major component or substantial structural part; roof. X owns a large retail store. X discovers a leak in the roof of the store and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the sheathing and rafters has rotted, and recommends the replacement of the entire roof. X pays the contractor to replace the entire roof with a new roof. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 14. Not replacement of major component or substantial structural part; roof membrane. X is in the business of manufacturing parts. X owns a factory facility in which the parts are manufactured. The roof over X’s facility is comprised of structural elements, insulation, and a waterproof membrane. Over time, the waterproof membrane began to wear and leakage began to occur. Consequently, X pays an amount to replace the plant’s worn roof membrane with a similar but new membrane. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The roof, including the membrane, is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Although the roof membrane may affect the function of the building structure, it is not, by itself, a major component or substantial structural part of X’s building structure under paragraph (i)(4) of this section. Because the roof membrane is not a major component or substantial structural part of the building structure, X is not required to treat the amount paid to replace the roof membrane as a restoration of the building structure under paragraph (i)(1)(vi) of this section. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs that directly benefit or are incurred by reason of production activities.

Example 15. Replacement of major component or substantial structural part; HVAC system. X owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of a furnace, an air conditioning unit, and duct work that runs throughout the building to distribute the heat or air conditioning throughout the building. The furnace in X’s building breaks down and X pays an amount to replace it with a new furnace. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The heating and air conditioning system, including the furnace, is a building system under paragraph 3(a)–3T.
Example 16. Replacement of major component or substantial structural part; HVAC system. X owns a building that it uses to operate its business. X pays an amount to replace the sprinkler system in the building with a new sprinkler system. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount paid to replace the sprinkler system as a restoration of a building system under paragraph (i)(1)(iv) of this section. The sprinkler system performs a discrete and critical function in the operation of the fire protection and alarm system, and is therefore a major component or substantial structural part of the fire protection and alarm system under paragraph (i)(4) of this section. Because the sprinkler system comprises a major component or substantial structural part of the building system under paragraph (i)(1)(iv) of this section, X must treat the amount paid to replace the sprinkler system as an improvement to the building. X is not required to treat the amount paid to replace the two roof-mounted heating/cooling units as a restoration of a building system under paragraph (i)(1)(vi) of this section.

Example 17. Not replacement of major component or substantial structural part; HVAC system. X owns a building that it uses to provide services to customers. The building contains an HVAC system that incorporates ten roof-mounted units that provide heating and air conditioning for different parts of the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building’s interior. X begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that X replace two of the roof-mounted units. X pays an amount to replace the two specified units. No work is performed on the other roof-mounted heating/cooling units, the duct work, or the controls. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The HVAC system, including the two roof-mounted units, is a building system under paragraph (e)(2)(i)(B)(4) of this section. The two roof-mounted heating/cooling units, by themselves, do not comprise a major component or substantial structural part of the building system. Accordingly, X is not required to treat the amount paid to replace the two roof-mounted heating/cooling units as a restoration of a building system under paragraph (i)(1)(vi) of this section.

Example 18. Replacement of major component or substantial structural part; electrical system. X owns a building that it uses to operate its business. X pays an amount to replace the wiring throughout the building with new wiring that meets building code requirements. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.
system, X must treat the amount as an improvement to the building. The electrical system, including the wiring, is a building system under paragraph (e)(2)(ii)(B)(3) of this section. The wiring performs a discrete and critical function in the operation of the electrical system and is therefore a major component or substantial structural part of the building. Under paragraph (i)(1)(vi) of this section, the wiring is a major component or substantial structural part of the building system. Therefore, in accordance with paragraph (e)(2)(ii)(B)(3) of this section, X must capitalize the amount paid to replace the wiring as a restoration to a building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii)(B)(3) of this section, X must capitalize the amount paid to restore the plumbing system as an improvement to the building and must capitalize these amounts under paragraph (i)(1)(vi) of this section.

Example 20. Replacement of major component or substantial structural part; plumbing system. X owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men’s and women’s restrooms on two of the three floors. X decides to update the restrooms by paying an amount to replace the plumbing fixtures in all of the restrooms, including the toilets, sinks, and associated fixtures, with modern style plumbing fixtures of similar quality and function. X does not replace the pipes connecting the fixtures to the building’s plumbing system. Under paragraph (e)(2)(ii)(B)(2) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. The plumbing fixtures in all the restrooms perform a discrete and critical function in the operation of the plumbing system and comprise a large portion of the physical structure of plumbing systems. Therefore, under paragraph (e)(2)(ii)(B)(2) of this section, the plumbing fixtures comprise a major component or substantial structural part of the plumbing system, and X must treat the amount paid as an improvement to the building. X must treat the amount paid to replace the sinks as an improvement to the building system and must capitalize these amounts under paragraph (i)(1)(vi) of this section.

Example 21. Not replacement of major component or substantial structural part; plumbing system. Assume the same facts as Example 20 except that X does not update all the bathroom fixtures. Instead, X only pays an amount to replace three of the twenty sinks located in the various restrooms because these sinks had cracked. The three replaced sinks, by themselves, do not comprise a large portion of the physical structure of the plumbing system nor do they perform a discrete and critical function in the operation of the plumbing system and are therefore not major components or substantial structural parts of the building system. Under paragraph (i)(1)(iv) of this section, these sinks do not constitute a major component or substantial structural part of the building system. Therefore, under paragraph (i)(1)(iv) of this section, X must treat the amount paid to replace the sinks as a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 22. Replacement of major component or substantial structural part; remodel. (i) X owns and operates a hotel building. X decides to attract customers and to remain competitive, it needs to update the hotel’s plumbing system. Accordingly, X pays amounts to replace the bathtubs, toilets, sinks, plumbing fixtures, and to repair, repaint, and retile the bathroom walls and floors, which allows X to update the plumbing system. The new plumbing components comprise a discrete and critical function in the operation of the plumbing system and comprise a large portion of the physical structure of the plumbing system. X must treat this amount as an improvement to the building and must capitalize these amounts under paragraph (i)(1)(vi) of this section. In Year 1, X pays amounts to complete the renovation of the remaining floors over the next 2 years.

(ii) Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the bathtubs, toilets, sinks, and plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(2) of this section. All the bathtubs, toilets, sinks, and plumbing fixtures in the hotel building perform a discrete and critical function in the operation of the plumbing system and comprise a large portion of the physical structure of the plumbing system. Therefore, under paragraph (i)(4) of this section, these plumbing components comprise major components or substantial structural parts of the plumbing system, and X must treat the amount paid to replace these plumbing components as a restoration of a building system under paragraph (i)(1)(vi) of this section. In addition, under paragraph (i)(1)(vi) of this section, X must treat the costs of repairing, repainting, and retiling the bathroom walls and floors as improvement costs because these costs directly benefit and are incurred by reason of the improvement to the plumbing system. Further, under paragraph (i)(4)
of this section, X must treat the costs incurred in Years 1, 2, and 3 for the bathroom remodeling as improvement costs, even though they are incurred over a period of several taxable years, because they are part of the aggregate of related amounts paid to improve the plumbing system. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must capitalize the amounts paid to improve the plumbing system as the costs of improving the building and must capitalize the amounts under paragraph (d)(2) of this section. In addition, X must capitalize the amounts paid to acquire and install each section 1245 property under §1.263(a)–2T of the regulations.

Example 23. Not replacement of major component or substantial structural part; windows. X owns a large office building that it uses to provide office space for employees that manage X’s operations. The building has 300 exterior windows. In Year 1, X pays an amount to replace 30 of the exterior windows that had become damaged. At the time of these replacements, X has no plans to replace any other windows in the near future. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The exterior windows are part of the building structure as defined under paragraph (e)(2)(i)(A) of this section. The 30 replacement windows do not comprise a large portion of the physical structure of the office building structure and, by themselves, do not perform a discrete and critical function in the operation of X’s building structure. Therefore, under paragraph (i)(4) of this section, the replacement windows do not constitute major components or substantial structural parts of the building structure. X must treat the amount as an improvement to the building. The exterior windows are part of the building structure as defined under paragraph (e)(2)(i)(A) of this section. The 30 replacement windows do not comprise a large portion of the physical structure of the office building structure and, by themselves, do not perform a discrete and critical function in the operation of X’s building structure. Therefore, under paragraph (i)(4) of this section, the replacement windows do not comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the windows as a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 24. Replacement of major component or substantial structural part; windows. Assume the same facts as Example 23 except that X replaces 200 of the 300 windows on the building. In addition, as a result of damage caused during the window replacements, X also pays an amount to repaint the interior trims associated with the replaced windows. The 200 replacement windows comprise a large portion of the physical structure of X’s building and perform a discrete and critical function in the operation of the building structure. Therefore, under paragraph (1)(4) of this section, the 200 windows comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the windows as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid to restore the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.

Example 25. Not replacement of major component or substantial structural part; floors. X owns and operates a hotel building. X decides to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises a small portion of the entire hotel building. X pays an amount to replace the wood flooring in the lobby with new wood flooring. X did not replace any other flooring in the building. Assume that the wood flooring constitutes section 1250 property. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The wood flooring is part of the building structure under paragraph (e)(2)(i)(A) of this section. The replacement wood flooring in the lobby of the building does not comprise a large portion of the physical structure of the hotel building or perform a discrete and critical function in the operation of the hotel building structure. Therefore, under paragraph (i)(4) of this section, the wood flooring does not comprise a major component or substantial structural part of the hotel building structure. Accordingly, X is not required to treat the amount paid to replace the wood flooring in the hotel lobby as a restoration under paragraph (i)(1)(vi) of this section.

Example 26. Replacement of major component or substantial structural part; floors. X owns and operates a hotel building. X decides to refresh the appearance of all the public areas of the hotel by replacing the floors. To that end, X pays an amount to replace all the wood floors in all the public areas of the hotel building with new wood floors. The public areas include the lobby, the hallways, the meeting rooms, and other public rooms throughout the hotel interiors. The replacement wood floors in all the public areas comprise a large portion of the physical structure of the hotel building structure and perform a discrete and critical function in the operation of X’s hotel building structure. Therefore, under paragraph (i)(4) of this section, replacement wood floors comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the floors as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid to restore the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.

(j) Capitalization of amounts to adapt property to a new or different use—(1) In
example may be subject to capitalization under a different provision of this section or another provision of the Internal Revenue Code (for example, section 263A). Unless otherwise stated, assume that X has not properly deducted a loss for any unit of property, asset, or component of a unit of property that is removed and replaced.

Example 1. New or different use. X is a manufacturer and owns a manufacturing building that it has used to manufacture goods since Year 1, when X placed it in service. In Year 30, X pays an amount to convert its manufacturing building into a showroom for its business. To convert the facility, X removes and replaces various structural components to provide a better layout for the showroom and its offices. X also repaints the building interiors as part of the conversion. None of the materials used are better than existing materials in the building. Under paragraph (e)(2)(ii) of this section, if the amount paid to adapt the building structure to a new or different use, X must treat the amount as an improvement to the building. Under paragraph (j)(1) of this section, the amount paid to convert the manufacturing facility into a showroom adapts the building structure to a new or different use because the conversion is not consistent with X’s intended ordinary use of the building structure at the time it was placed in service. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid for the adaptation of the building structure as an amount that improves the building. Accordingly, X must capitalize the amount as an improvement under paragraph (d)(3) of this section.

Example 2. Not a new or different use. X owns a building consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. One of the tenants expands its occupancy to include two adjoining retail spaces. To facilitate the new lease, X pays an amount to remove the walls between the three retail spaces. Assume that the walls between spaces are part of the building and its structural components. Under paragraph (d)(3) of this section, if the amount paid to adapt the building structure to a new or different use, X must treat the amount as an improvement to the building. Under paragraph (j)(1) of this section, the amount paid to convert three retail spaces into one larger space for an existing tenant does not adapt X’s building structure to a new or different use because the combination of retail spaces is consistent with X’s intended, ordinary use of the building structure. Therefore, the amount paid by X to remove the walls does not improve the building under paragraph (d)(3) of this section.

Example 3. Not a new or different use. X owns a building consisting of twenty retail spaces. X decides to sell the building. In anticipation of selling the building, X pays an amount to repaint the interior walls and to refinish the hardwood floors. Under paragraph (e)(2)(ii) of this section, if the amount paid adapts the building structure to a new or different use, X must treat the amount as an improvement to the building. Preparing the building for sale does not constitute a new or different use for the building structure under paragraph (j)(1) of this section. Therefore, the amount paid to prepare the building structure for sale does not improve the building under paragraphs (d)(3) of this section.

Example 4. New or different use. X owns a parcel of land on which it previously operated a manufacturing facility. Assume that the land is the unit of property. During the course of X’s operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. X discontinues manufacturing operations at the site, and decides to sell the property to a developer that intends to use the property for residential housing. In anticipation of selling the land, X pays an amount to clean up the land to a standard that is required for the land to be used for residential purposes. In addition, X pays an amount to regrade the land so that it can be used for residential purposes. Amounts that X pays to cleanup wastes that were discharged in the course of X’s manufacturing operations do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned. Therefore, X is not required to capitalize the amount paid for the cleanup under paragraph (j)(1) of this section. However, the amount paid to regrade the land so that it can be used for residential purposes adapts the land...
to a new or different use that is inconsistent with X’s intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid to regrade the property must be capitalized as improvements under paragraphs (j)(1) of this section.

(k) Optional regulatory accounting method—(1) In general. This paragraph (k) provides an optional simplified method (the regulatory accounting method) for regulated taxpayers to determine whether amounts paid to repair, maintain, or improve tangible property are to be treated as deductible expenses or capital expenditures. A taxpayer that uses the regulatory accounting method described in paragraph (k)(3) of this section must use that method for property subject to regulatory accounting instead of determining whether amounts paid to repair, maintain, or improve property are capital expenditures or deductible expenses under the general principles of sections 162(a), 212, and 263(a). Thus, the capitalization rules in paragraph (d) (and the routine maintenance safe harbor described in paragraph (g)) of this section do not apply to amounts paid to repair, maintain, or improve property subject to regulatory accounting by taxpayers that use the regulatory accounting method under this paragraph (k). However, section 263A continues to apply to costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) Eligibility for regulatory accounting method. A taxpayer that is engaged in a trade or business in a regulated industry may use the regulatory accounting method under this paragraph (k). For purposes of this paragraph (k), a taxpayer in a regulated industry is a taxpayer that is subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB).

(3) Description of regulatory accounting method. Under the regulatory accounting method, a taxpayer must follow its method of accounting for regulatory accounting purposes in determining whether an amount paid improves property under this section. Therefore, a taxpayer must capitalize for Federal income tax purposes an amount paid that is capitalized as an improvement for regulatory accounting purposes. A taxpayer must not capitalize for Federal income tax purposes under this section an amount paid that is not capitalized as an improvement for regulatory accounting purposes.

Example 1. Taxpayer subject to regulatory accounting rules of FERC. X is an electric utility company that generates electricity and that owns and operates network assets to transmit and distribute the electricity to its customers. X is subject to the regulatory accounting rules of FERC and X chooses to use the regulatory accounting method under paragraph (k) of this section. X must not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets. Under the regulatory accounting method, X must not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets. X does not capitalize on its books and records for regulatory accounting purposes the cost of repairs and maintenance performed on its turbines or its network assets. Under the regulatory accounting method, X must not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets.

Example 2. Taxpayer not subject to regulatory accounting rules of FERC. X is an electric utility company that operates a power plant to generate electricity. X previously was subject to the regulatory accounting rules of FERC but, for various reasons, X is no longer required to use FERC’s regulatory accounting rules. X cannot use the regulatory accounting method provided in this paragraph (k).

Example 3. Taxpayer subject to regulatory accounting rules of FCC. X is a telecommunications company that is subject to the regulatory accounting rules of the FCC. X chooses to use the regulatory accounting method under this paragraph (k). X’s assets include a telephone central office switching center, which contains numerous switches and various switching equipment. X capitalizes on its books and records for regulatory accounting purposes the cost of replacing each switch. Under the regulatory accounting
method, X is required to capitalize for Federal income tax purposes amounts paid to replace each switch.

Example 4. Taxpayer subject to regulatory accounting rules of STB. X is a Class I railroad that is subject to the regulatory accounting rules of the STB. X chooses to use the regulatory accounting method under this paragraph (k). X capitalizes on its books and records for regulatory accounting purposes the cost of locomotive rebuilds. Under the regulatory accounting method, X is required to capitalize for federal income tax purposes amounts paid to rebuild its locomotives.

(l) Methods of accounting authorized in published guidance. A taxpayer may use a repair allowance method of accounting or any other method of accounting that is authorized in published guidance in the Federal Register or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter).

(m) Treatment of capital expenditures. Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs. See section 263A for the treatment of direct and indirect costs of producing property or acquiring property for resale.

(n) Recovery of capitalized amounts. Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to the use, sale, or disposition of property.

(o) Accounting method changes. Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446-1(e) and follow the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner’s consent to change its accounting method.

(p) Effective/applicability date. This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see §1.263(a)-3 in effect prior to January 1, 2012 (§1.263(a)-3 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(q) Expiration date. The applicability of this section expires on December 23, 2014.


EDITORIAL NOTE: At 77 FR 18688, Mar. 28, 2012, §1.263(a)-3T was amended; however, the amendment could not be incorporated due to inaccurate amendatory instruction.

§1.263(a)-4 Amounts paid to acquire or create intangibles.

(a) Overview. This section provides rules for applying section 263(a) to amounts paid to acquire or create intangibles. Except to the extent provided in paragraph (d)(8) of this section, the rules provided by this section do not apply to amounts paid to acquire or create tangible assets. Paragraph (b) of this section provides a general principle of capitalization. Paragraphs (c) and (d) of this section identify intangibles for which capitalization is specifically required under the general principle. Paragraph (e) of this section provides rules for determining the extent to which taxpayers must capitalize transaction costs. Paragraph (f) of this section provides a 12-month rule intended to simplify the application of the general principle to certain payments that create benefits of brief duration. Additional rules and examples relating to these provisions are provided in paragraphs (g) through (n) of this section. The applicability date of the rules in this section is provided in paragraph (o) of this section. Paragraph (p) of this section provides rules applicable to changes in methods of accounting made to comply with this section.

(b) Capitalization with respect to intangibles—(1) In general. Except as otherwise provided in this section, a taxpayer must capitalize—
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(i) An amount paid to acquire an intangible (see paragraph (c) of this section);

(ii) An amount paid to create an intangible described in paragraph (d) of this section;

(iii) An amount paid to create or enhance a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section;

(iv) An amount paid to create or enhance a future benefit identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter) as an intangible for which capitalization is required under this section; and

(v) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) an acquisition or creation of an intangible described in paragraph (b)(1)(iv) of this section.

(2) Published guidance. Any published guidance identifying a future benefit as an intangible for which capitalization is required under paragraph (b)(1)(iv) of this section applies only to amounts paid on or after the date of publication of the guidance.

(3) Separate and distinct intangible asset—(i) Definition. The term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money’s worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. In addition, for purposes of this section, a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer. The determination of whether a payment creates a separate and distinct intangible asset is made based on all of the facts and circumstances existing during the taxable year in which the payment is made.

(ii) Creation or termination of contract rights. Amounts paid to another party to create, originate, enter into, renew or renegotiate an agreement with that party that produces rights or benefits for the taxpayer (and amounts paid to facilitate the creation, origination, enhancement, renewal or renegotiation of such an agreement) are treated as amounts that do not create (or facilitate the creation of) a separate and distinct intangible asset within the meaning of this paragraph (b)(3). Further, amounts paid to another party to terminate (or facilitate the termination of) an agreement with that party are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). See paragraphs (d)(2), (d)(6), and (d)(7) of this section for rules that specifically require capitalization of amounts paid to create or terminate certain agreements.

(iii) Amounts paid in performing services. Amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3), regardless of whether the amounts result in the creation of an income stream under the agreement.

(iv) Creation of computer software. Except as otherwise provided in the Internal Revenue Code, the regulations thereunder, or other published guidance in the Federal Register or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), amounts paid to develop computer software are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3).

(v) Creation of package design. Amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). For purposes of this section, the term package design means the specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and other elements on a given product package, or the design of a container with respect to its shape or function.

(4) Coordination with other provisions of the Internal Revenue Code—(1) In general. Nothing in this section changes the treatment of an amount that is specifically provided for under any
other provision of the Internal Revenue Code (other than section 162(a) or 212) or the regulations thereunder.

(ii) Example. The following example illustrates the rule of this paragraph (b)(4):

Example. On January 1, 2004, G enters into an interest rate swap agreement with unrelated counterparty H under which, for a term of five years, G is obligated to make annual payments at 11% and H is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time G and H enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 2004, H pays G a yield adjustment fee of $3,790,786. This yield adjustment fee constitutes an amount paid to create an intangible and would be capitalized under paragraph (d)(2) of this section. However, because the yield adjustment fee is a nonperiodic payment on a notional principal contract as defined in §1.446–3(c), the treatment of this fee is governed by §1.446–3 and not this section.

(c) Acquired intangibles—(1) In general. A taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Examples of intangibles within the scope of this paragraph (c) include, but are not limited to, the following (if acquired from another party in a purchase or similar transaction):

(i) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity.

(ii) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes.

(iii) A financial instrument, such as—

(A) A notional principal contract;

(B) A foreign currency contract;

(C) A futures contract;

(D) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property));

(E) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); and

(F) Any other financial derivative.

(iv) An endowment contract, annuity contract, or insurance contract.

(v) Non-functional currency.

(vi) A lease.

(vii) A patent or copyright.

(viii) A franchise, trademark or trade name (as defined in §1.197–2(b)(10)).

(ix) An assembled workforce (as defined in §1.197–2(b)(3)).

(x) Goodwill (as defined in §1.197–2(b)(1)) or going concern value (as defined in §1.197–2(b)(2)).

(xi) A customer list.

(xii) A servicing right (for example, a mortgage servicing right that is not treated for Federal income tax purposes as a stripped coupon).

(xiii) A customer-based intangible (as defined in §1.197–2(b)(6)) or supplier-based intangible (as defined in §1.197–2(b)(7)).

(xiv) Computer software.

(xv) An agreement providing either party the right to use, possess or sell an intangible described in paragraphs (c)(1)(i) through (v) of this section.

(2) Readily available software. An amount paid to obtain a nonexclusive license for software that is (or has been) readily available to the general public on similar terms and has not been substantially modified (within the meaning of §1.197–2(c)(4)) is treated for purposes of this paragraph (c) as an amount paid to another party to acquire an intangible from that party in a purchase or similar transaction.

(3) Intangibles acquired from an employee. Amounts paid to an employee to acquire an intangible from that employee are not required to be capitalized under this section if the amounts are includible in the employee’s income in connection with the performance of services under section 61 or 83.

For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(4) Examples. The following examples illustrate the rules of this paragraph (c):
Example 1. Debt instrument. X corporation, a commercial bank, purchases a portfolio of existing loans from Y corporation, another financial institution. X pays Y $2,000,000 in exchange for the portfolio. The $2,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation holds a call option entitling it to purchase from W all of the outstanding stock of X at a certain price per share. Z corporation acquires the call option from Y in exchange for $5,000,000. The $5,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 3. Ownership interest in a corporation. Same as Example 2, but assume Z exercises its option and purchases from W all of the outstanding stock of X in exchange for $100,000,000. The $100,000,000 paid to W constitutes an amount paid to acquire an intangible from W and must be capitalized.

Example 4. Customer list. N corporation, a retailer, sells its products through its catalog and mail order system. N purchases a customer list from R corporation. N pays R $100,000 in exchange for the customer list. The $100,000 paid to R constitutes an amount paid to acquire an intangible from R and must be capitalized.

Example 5. Goodwill. Z corporation pays W corporation $10,000,000 to purchase all of the assets of W in a transaction that constitutes an applicable asset acquisition under section 1060(c). Of the $10,000,000 consideration paid in the transaction, $9,000,000 is allocable to tangible assets purchased from W and $1,000,000 is allocable to goodwill. The $1,000,000 allocable to goodwill constitutes an amount paid to W to acquire an intangible from W and must be capitalized.

(d) Created intangibles—(1) In general. Except as provided in paragraph (f) of this section (relating to the 12-month rule), a taxpayer must capitalize amounts paid to create an intangible described in this paragraph (d). The determination of whether an amount is paid to create an intangible described in this paragraph (d) is to be made based on all of the facts and circumstances, disregarding distinctions between the labels used by the taxpayer and other parties to the transaction.

(2) Financial interests—(i) In general. A taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the following financial interests, whether or not the interest is regularly traded on an established market:

(A) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity.

(B) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for Federal income tax purposes.

(C) A financial instrument, such as—

(1) A letter of credit;

(2) A credit card agreement;

(3) A notional principal contract;

(4) A foreign currency contract;

(5) A futures contract;

(6) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property));

(7) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); and

(8) Any other financial derivative.

(D) An endowment contract, annuity contract, or insurance contract that has or may have cash value.

(E) Non-functional currency.

(F) An agreement providing either party the right to use, possess or sell a financial interest described in this paragraph (d)(2).

(ii) Amounts paid to create, originate, enter into, renew or renegotiate. An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate a financial interest with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of a financial interest with that party.

(iii) Renegotiate. A taxpayer is treated as renegotiating a financial interest if the terms of the financial interest are modified. A taxpayer also is treated
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as renegotiating a financial interest if the taxpayer enters into a new financial interest with the same party (or substantially the same parties) to a terminated financial interest, the taxpayer could not cancel the terminated financial interest without the consent of the other party (or parties), and the other party (or parties) would not have consented to the cancellation unless the taxpayer entered into the new financial interest. A taxpayer is treated as unable to cancel a financial interest without the consent of the other party (or parties) if, under the terms of the financial interest, the taxpayer is subject to a termination penalty and the other party (or parties) to the financial interest modifies the terms of the penalty.

(iv) Coordination with other provisions of this paragraph (d). An amount described in this paragraph (d)(2) that is also described elsewhere in paragraph (d) of this section is treated as described only in this paragraph (d)(2).

(v) Coordination with § 1.263(a)–5. See § 1.263(a)–5 for the treatment of borrowing costs and the treatment of amounts paid by an option writer.

(vi) Examples. The following examples illustrate the rules of this paragraph (d)(2):

Example 1. Loan. X corporation, a commercial bank, makes a loan to A in the principal amount of $250,000. The $250,000 principal amount of the loan paid to A constitutes an amount paid to another party to create a debt instrument with that party under paragraph (d)(2)(i)(B) of this section and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation pays W $1,000,000 in exchange for W’s grant of a 3-year call option to Y permitting Y to purchase all of the outstanding stock of X at a certain price per share. Y’s payment of $1,000,000 to W constitutes an amount paid to another party to create an option with that party under paragraph (d)(2)(i)(C)(7) of this section and must be capitalized.

Example 3. Partnership interest. Z corporation pays $10,000 to P, a partnership, in exchange for an ownership interest in P. Z’s payment of $10,000 to P constitutes an amount paid to another party to create an ownership interest in a partnership with that party under paragraph (d)(2)(i)(A) of this section and must be capitalized.

Example 4. Take or pay contract. Q corporation, a producer of natural gas, pays $1,000,000 to R during 2005 to induce R corporation to enter into a 5-year “take or pay” gas purchase contract. Under the contract, R is liable to pay for a specified minimum amount of gas, whether or not R takes such gas. Q’s payment of $1,000,000 is an amount paid to another party to induce that party to enter into an agreement providing Q the right and obligation to provide property or be compensated for such property (regardless of whether the property is provided) under paragraph (d)(2)(i)(C)(6) of this section and must be capitalized.

Example 5. Agreement to provide property. P corporation pays R corporation $1,000,000 in exchange for R’s agreement to purchase 1,000 units of P’s product at any time within the three succeeding calendar years. The agreement describes P’s $1,000,000 as a sales discount. P’s $1,000,000 payment is an amount paid to induce R to enter into an agreement providing P the right and obligation to provide property under paragraph (d)(2)(i)(C)(6) of this section and must be capitalized.

Example 6. Customer incentive payment. S corporation, a computer manufacturer, seeks to develop a business relationship with V corporation, a computer retailer. As an incentive to encourage V to purchase computers from S, S enters into an agreement with V under which S agrees that, if V purchases $20,000,000 of computers from S within 3 years from the date of the agreement, S will pay V $2,000,000 on the date that V reaches the $20,000,000 threshold. V reaches the $20,000,000 threshold during the third year of the agreement, and S pays V $2,000,000. S is not required to capitalize its payment to V under this paragraph (d)(2) because the payment does not provide S the right or obligation to provide property and does not create a separate and distinct intangible asset for S within the meaning of paragraph (b)(3)(1) of this section.

(3) Prepaid expenses—(1) In general. A taxpayer must capitalize prepaid expenses.

(ii) Examples. The following examples illustrate the rules of this paragraph (d)(3):

Example 1. Prepaid insurance. N corporation, an accrual method taxpayer, pays $10,000 to an insurer to obtain three years of coverage under a property and casualty insurance policy. The $10,000 is a prepaid expense and must be capitalized under this paragraph (d)(3). Paragraph (d)(2) of this section does not apply to the payment because the policy has no cash value.

Example 2. Prepaid rent. X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, X prepays $240,000. No other amounts are due under the lease. The
$240,000 is a prepaid expense and must be capitalized under this paragraph (d)(3).

(4) Certain memberships and privileges—(i) In general. A taxpayer must capitalize amounts paid to an organization to obtain, renew, renegotiate, or upgrade a membership or privilege from that organization. A taxpayer is not required to capitalize under this paragraph (d)(4) an amount paid to obtain, renew, renegotiate or upgrade certification of the taxpayer’s products, services, or business processes.

(ii) Examples. The following examples illustrate the rules of this paragraph (d)(4):

Example 1. Hospital privilege. B, a physician, pays $10,000 to Y corporation to obtain lifetime staff privileges at a hospital operated by Y. B must capitalize the $10,000 payment under this paragraph (d)(4).

Example 2. Initiation fee. X corporation pays a $50,000 initiation fee to obtain membership in a trade association. X must capitalize the $50,000 payment under this paragraph (d)(4).

Example 3. Product rating. V corporation, an automobile manufacturer, pays W corporation, a national quality ratings association, $100,000 to conduct a study and provide a rating of the quality and safety of a line of V’s automobiles. V’s payment is an amount paid to obtain a certification of V’s product and is not required to be capitalized under this paragraph (d)(4).

Example 4. Business process certification. Z corporation, a manufacturer, seeks to obtain a certification that its quality control standards meet a series of international standards known as ISO 9000. Z pays $50,000 to an independent registrar to obtain a certification from the registrar that Z’s quality management system conforms to the ISO 9000 standard. Z’s payment is an amount paid to obtain a certification of Z’s business processes and is not required to be capitalized under this paragraph (d)(4).

(5) Certain rights obtained from a governmental agency—(i) In general. A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

(ii) Examples. The following examples illustrate the rules of this paragraph (d)(5):

Example 1. Business license. X corporation pays $15,000 to state Y to obtain a business license that is valid indefinitely. Under this paragraph (d)(5), the amount paid to state Y is an amount paid to a government agency for a right granted by that agency.

Example 2. Bar admission. A, an individual, pays $1,000 to an agency of state Z to obtain a license to practice law in state Z that is valid indefinitely, provided A adheres to the requirements governing the practice of law in state Z. Under this paragraph (d)(5), the amount paid to state Z is an amount paid to a government agency for a right granted by that agency. Accordingly, A must capitalize the $1,000 payment.

(6) Certain contract rights—(i) In general. Except as otherwise provided in this paragraph (d)(6), a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party—

(A) An agreement providing the taxpayer the right to use tangible or intangible property or the right to be compensated for the use of tangible or intangible property;

(B) An agreement providing the taxpayer the right to provide or to receive services (or the right to be compensated for services regardless of whether the taxpayer provides such services);

(C) A covenant not to compete or an agreement having substantially the same effect as a covenant not to compete (except, in the case of an agreement that requires the performance of services, to the extent that the amount represents reasonable compensation for services actually rendered);

(D) An agreement not to acquire additional ownership interests in the taxpayer; or

(E) An agreement providing the taxpayer (as the covered party) with an annuity, an endowment, or insurance coverage.

(ii) Amounts paid to create, originate, enter into, renew or renegotiate. An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate an agreement with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of an agreement with that party.

(iii) Renegotiate. A taxpayer is treated as renegotiating an agreement if the
terms of the agreement are modified. A taxpayer also is treated as renegotiating an agreement if the taxpayer enters into a new agreement with the same party (or substantially the same parties) to a terminated agreement, the taxpayer could not cancel the terminated agreement without the consent of the other party (or parties), and the other party (or parties) would not have consented to the cancellation unless the taxpayer entered into the new agreement. A taxpayer is treated as unable to cancel an agreement without the consent of the other party (or parties) if, under the terms of the agreement, the taxpayer is subject to a termination penalty and the other party (or parties) to the agreement modifies the terms of the penalty.

(iv) Right. An agreement does not provide the taxpayer a right to use property or to provide or receive services if the agreement may be terminated at will by the other party (or parties) to the agreement before the end of the period prescribed by paragraph (f)(1) of this section. An agreement is not terminable at will if the other party (or parties) to the agreement is economically compelled not to terminate the agreement until the end of the period prescribed by paragraph (f)(1) of this section. All of the facts and circumstances will be considered in determining whether the other party (or parties) to an agreement is economically compelled not to terminate the agreement. An agreement also does not provide the taxpayer the right to provide services if the agreement merely provides that the taxpayer will stand ready to provide services if requested, but places no obligation on another person to request or pay for the taxpayer's services.

(v) De minimis amounts. A taxpayer is not required to capitalize amounts paid to another party (or parties) to create, originate, enter into, renew or renegotiate with that party (or those parties) an agreement described in paragraph (d)(6)(i) of this section if the aggregate of all amounts paid to that party (or those parties) with respect to the agreement does not exceed $5,000. If the aggregate of all amounts paid to the other party (or parties) with respect to that agreement exceeds $5,000, then all amounts must be capitalized. For purposes of this paragraph (d)(6), an amount paid in the form of property is valued at its fair market value at the time of the payment. In general, a taxpayer must determine whether the rules of this paragraph (d)(6)(v) apply by accounting for the specific amounts paid with respect to each agreement. However, a taxpayer that reasonably expects to create, originate, enter into, renew or renegotiate at least 25 similar agreements during the taxable year may establish a pool of agreements for purposes of determining the amounts paid with respect to the agreements in the pool. Under this pooling method, the amount paid with respect to each agreement included in the pool is equal to the average amount paid with respect to all agreements included in the pool. A taxpayer computes the average amount paid with respect to all agreements included in the pool by dividing the sum of all amounts paid with respect to all agreements included in the pool by the number of agreements included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(vi) Exception for lessee construction allowances. Paragraph (d)(6)(i) of this section does not apply to amounts paid by a lessor to a lessee as a construction allowance to the extent the lessee expends the amount for the tangible property that is owned by the lessor for Federal income tax purposes (see, for example, section 110).

(vii) Examples. The following examples illustrate the rules of this paragraph (d)(6):

Example 1. New lease agreement. V seeks to lease commercial property in a prominent downtown location of city R. V pays Z, the owner of the commercial property, $50,000 in exchange for Z entering into a 10-year lease with V. V’s payment is an amount paid to another party to enter into an agreement providing V the right to use tangible property. Because the $50,000 payment exceeds $5,000, no portion of the amount paid to Z is de minimis for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, V must capitalize the entire $50,000 payment.

Example 2. Modification of lease agreement. Partnership Y leases a piece of equipment for use in its business from Z corporation. When the lease has a remaining term of 3 years, Y requests that Z modify the existing lease by
Example 6. Covenant not to compete. R enters into a 5-year, non-cancelable lease of a mainframe computer for use in its business. R subsequently determines that the mainframe computer that R is leasing is no longer adequate for its needs. In 2006, R and P corporation (the lessor) agree to terminate the 2004 lease and to enter into a new 5-year lease for a different and more powerful mainframe computer. R pays P a $75,000 early termination fee. P would not have agreed to terminate the 2004 lease unless R agreed to enter into the 2006 lease. R’s payment of $75,000 is an amount paid to another party to renegotiate an agreement providing R the right to use property. Because the $75,000 payment exceeds $5,000, no portion of the amount paid to P is de minimis for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, R must capitalize the entire $75,000 payment.

Example 3. Modification of lease agreement. In 2004, R enters into a 5-year, non-cancelable lease of a mainframe computer in exchange for Z’s agreement to modify the existing lease. Z’s payment of $50,000 is an amount paid to another party to renegotiate an agreement providing Y the right to use property. Because the $50,000 payment exceeds $5,000, no portion of the amount paid to Z is de minimis for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, Y must capitalize the entire $50,000 payment.

Example 7. Standstill agreement. During 2004 through 2005, X corporation acquires a large minority interest in the stock of Z corporation. To ensure that X does not take control of Z, Z pays X $5,000,000 for a standstill agreement under which X agrees not to acquire any more stock in Z for a period of 10 years. Z’s payment is an amount paid to another party to enter into an agreement not to acquire additional ownership interests in Z. Because the $5,000,000 payment exceeds $5,000, no portion of the amount paid to X is de minimis for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(D) of this section, Z must capitalize the entire $5,000,000 payment.

Example 8. Signing bonus. Employer B pays $25,000 signing bonus to employee C to induce C to come to work for B. C can leave B’s employment at any time to work for a competitor of B and is not required to repay the $25,000 bonus to B. Because C is not economically compelled to continue his employment with B, B’s payment does not provide B the right to receive services from C. Accordingly, B is not required to capitalize the $25,000 payment.

Example 9. Renewal. In 2000, M corporation and N corporation enter into a 5-year agreement that gives M the right to manage N’s investment portfolio. In 2005, N has the option of renewing the agreement for another three years. During 2004, M pays $10,000 to send several employees of N to an investment seminar. M pays the $10,000 to help develop and maintain its business relationship with N with the expectation that N will renew its agreement with M in 2005. Because M’s payment is not contingent on N agreeing to renew the agreement, M’s payment is not an amount paid to renew an agreement under paragraph (d)(6)(i) of this section and is not required to be capitalized.

Example 10. De minimis payments. X corporation is engaged in the business of providing wireless telecommunications services to customers. To induce customer B to enter into a 3-year non-cancelable telecommunications contract, X provides B with a free wireless telephone. The fair market value of the wireless telephone is $300 at the time it is provided to B. X’s provision of a wireless telephone to B is an amount paid to B to induce B to enter into an agreement providing X the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Because the amount of the inducement is $300, the amount of the inducement is de minimis under paragraph (d)(6)(v) of this section. Accordingly, X is not required to capitalize the amount of the inducement provided to B.

(7) Certain contract terminations—(1) In general. A taxpayer must capitalize amounts paid to another party to terminate—
(A) A lease of real or tangible personal property between the taxpayer (as lessor) and that party (as lessee); 

(B) An agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business (other than an intangible described in paragraph (c)(1)(i) through (iv) of this section or a financial interest described in paragraph (d)(2) of this section); or 

(C) An agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party. 

(ii) Certain break-up fees. Paragraph (d)(7)(i) of this section does not apply to the termination of a transaction described in §1.263(a)-(5)(a) (relating to an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions). See §1.263(a)-(5)(c)(8) for rules governing the treatment of amounts paid to terminate a transaction to which that section applies. 

(iii) Examples. The following examples illustrate the rules of this paragraph (d)(7): 

Example 1. Termination of exclusive license agreement. On July 1, 2005, N enters into a license agreement with R corporation under which N grants R the exclusive right to manufacture and distribute goods using N's design and trademarks for a period of 10 years. On June 30, 2007, N pays R $5,000,000 in exchange for R's agreement to terminate the exclusive license agreement. N's payment to terminate its license agreement with R constitutes a payment to terminate an exclusive license to use the taxpayer's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, N must capitalize its $5,000,000 payment to R. 

Example 2. Termination of exclusive distribution agreement. On March 1, 2005, L, a manufacturer, enters into an agreement with M granting M the right to be the sole distributor of L's products in state X for 10 years. On July 1, 2008, L pays M $50,000 in exchange for M's agreement to terminate the distribution agreement. L's payment to terminate its agreement with M constitutes a payment to terminate an exclusive right to acquire L's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, L must capitalize its $50,000 payment to M. 

Example 3. Termination of covenant not to compete. On February 1, 2005, Y corporation enters into a covenant not to compete with Z corporation that prohibits Y from competing with Z in city V for a period of 5 years. On January 31, 2007, Y pays Z $1,000,000 in exchange for Z's agreement to terminate the covenant not to compete. Y's payment to terminate the covenant not to compete with Z constitutes a payment to terminate an agreement that prohibits Y from competing with Z, as described in paragraph (d)(7)(i)(C) of this section. Accordingly, Y must capitalize its $1,000,000 payment to Z. 

Example 4. Termination of merger agreement. N corporation and U corporation enter into an agreement under which N agrees to merge into U. Subsequently, N pays U $10,000,000 to terminate the merger agreement. As provided in paragraph (d)(7)(ii) of this section, N's $10,000,000 payment to terminate the merger agreement with U is not required to be capitalized under this paragraph (d)(7). In addition, N's $10,000,000 does not create a separate and distinct intangible asset for N within the meaning of paragraph (b)(3)(i) of this section. (See §1.263(a)-(5) for additional rules regarding termination of merger agreements). 

(8) Certain benefits arising from the provision, production, or improvement of real property—(i) In general. A taxpayer must capitalize amounts paid for real property if the taxpayer transfers ownership of the real property to another person (except to the extent the real property is sold for fair market value) and if the real property can reasonably be expected to produce significant economic benefits to the taxpayer after the transfer. A taxpayer also must capitalize amounts paid to produce or improve real property owned by another (except to the extent the real property is sold for fair market value to produce or improve the real property) if the real property can reasonably be expected to produce significant economic benefits for the taxpayer. 

(ii) Exclusions. A taxpayer is not required to capitalize an amount under paragraph (d)(8)(i) of this section if the taxpayer transfers real property or pays an amount to produce or improve real property owned by another in exchange for services, the purchase or use of property, or the creation of an intangible described in paragraph (d) of this section (other than in this paragraph (d)(8)). The preceding sentence does not apply to the extent the taxpayer does not receive fair market value consideration for the real property that is relinquished or for the
amounts that are paid by the taxpayer to produce or improve real property owned by another.

(iii) Real property. For purposes of this paragraph (d)(8), real property includes property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as roads, bridges, tunnels, pavements, wharves and docks, breakwaters and sea walls, elevators, power generation and transmission facilities, and pollution control facilities.

(iv) Impact fees and dedicated improvements. Paragraph (d)(8)(i) of this section does not apply to amounts paid to satisfy one-time charges imposed by a State or local government against new development (or expansion of existing development) to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. In addition, paragraph (d)(8)(i) of this section does not apply to amounts paid for real property or improvements to real property constructed by the taxpayer where the real property or improvements benefit new development or expansion of existing development, are immediately transferred to a State or local government for dedication to the general public use, and are maintained by the State or local government. See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in this paragraph (d)(8)(i).

(v) Examples. The following examples illustrate the rules of this paragraph (d)(8):

Example 1. Amount paid to produce real property owned by another. W corporation operates a quarry on the east side of a river in city Z and a crusher on the west side of the river. City Z’s existing bridges are of insufficient capacity to be traveled by trucks in transferring stone from W’s quarry to its crusher. As a result, the efficiency of W’s operations is greatly reduced. W contributes $1,000,000 to city Z to defray in part the cost of constructing a publicly owned bridge capable of accommodating W’s trucks. W’s payment to city Z is an amount paid to produce or improve real property (within the meaning of paragraph (d)(8)(i) of this section) that can reasonably be expected to produce significant economic benefits for W. Under paragraph (d)(8)(i) of this section, W must capitalize the $1,000,000 paid to city Z.

Example 2. Transfer of real property to another. K corporation, a shipping company, uses smaller vessels to unload its ocean-going vessels at port X. There is no natural harbor at port X, and during stormy weather the transfer of freight between K’s ocean vessels and port X is extremely difficult and sometimes impossible, which can be very costly to K. Consequently, K constructs a short breakwater at a cost of $50,000. The short breakwater, however, is inadequate, so K persuades the port authority to build a larger breakwater that will allow K to unload its vessels at any time of the year and during all kinds of weather. K contributes amounts to the port authority for use in building the larger breakwater. Because the transfer of the small breakwater and $200,000 is reasonably expected to produce significant economic benefits for K, K must capitalize both the adjustment basis of the small breakwater (determined at the time the small breakwater is contributed) and the $200,000 payment under this paragraph (d)(8).

Example 3. Dedicated improvements. X corporation is engaged in the development and sale of residential real estate. In connection with a residential real estate project under construction by X in city Z, X is required by city Z to construct ingress and egress roads to and from its project and immediately transfer the roads to city Z for dedication to general public use. The roads will be maintained by city Z. X pays its subcontractor $100,000 to construct the ingress and egress roads. X’s payment is a dedicated improvement within the meaning of paragraph (d)(8)(iv) of this section. Accordingly, X is not required to capitalize the $100,000 payment under this paragraph (d)(8). See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in paragraph (d)(8)(iv) of this section.

(9) Defense or perfection of title to intangible property.—(i) In general. A taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer’s title to the intangible property.

(ii) Certain break-up fees. Paragraph (d)(9)(i) of this section does not apply to the termination of a transaction described in §1.263(a)-5(a) (relating to an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions). See §1.263(a)-5 for rules governing the treatment of amounts paid to terminate a transaction to which that section applies. Paragraph (d)(9)(i) of this section also does not...
apply to an amount paid to another party to terminate an agreement that grants that party the right to purchase the taxpayer’s intangible property.

(ii) Example. The following example illustrates the rules of this paragraph (d)(9):

Example. Defense of title. R corporation claims to own an exclusive patent on a particular technology. U corporation brings a lawsuit against R, claiming that U is the true owner of the patent and that R stole the technology from U. The sole issue in the suit involves the validity of R’s patent. R chooses to settle the suit by paying U $100,000 in exchange for U’s release of all future claim to the patent. R’s payment to U is an amount paid to defend or perfect title to intangible property under paragraph (d)(9) of this section and must be capitalized.

(e) Transaction costs.—(1) Scope of facilitation. Except as otherwise provided in this section, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction.

(ii) Treatment of termination payments. An amount paid to terminate (or facilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement under this section. See paragraph (d)(6)(iii) of this section for the treatment of termination fees paid to the other party (or parties) of a renegotiated agreement.

(iii) Special rule for contracts. An amount is treated as not paid in the process of investigating or otherwise pursuing the creation of an agreement described in paragraph (d)(2) or (d)(6) of this section if the amount relates to activities performed before the earlier of the date the taxpayer begins preparing its bid for the agreement or the date the taxpayer begins discussing or negotiating the agreement with another party to the agreement.

(iv) Borrowing costs. An amount paid to facilitate a borrowing does not facilitate an acquisition or creation of an intangible described in paragraphs (b)(1)(i) through (iv) of this section. See §§1.263(a)–5 and 1.146–5 for the treatment of an amount paid to facilitate a borrowing.

(v) Special rule for stock redemption costs of open-end regulated investment companies. An amount paid by an open-end regulated investment company (within the meaning of section 851) to facilitate a redemption of its stock is treated as an amount that does not facilitate the acquisition of an intangible under this section.

(2) Coordination with paragraph (d) of this section. In the case of an amount paid to facilitate the creation of an intangible described in paragraph (d) of this section, the provisions of this paragraph (e) apply regardless of whether a payment described in paragraph (d) is made.

(3) Transaction. For purposes of this section, the term ‘transaction’ means all of the factual elements comprising an acquisition or creation of an intangible and includes a series of steps carried out as part of a single plan. Thus, a transaction can involve more than one invoice and more than one intangible. For example, a purchase of intangibles under one purchase agreement constitutes a single transaction, notwithstanding the fact that the acquisition involves multiple intangibles and the amounts paid to facilitate the acquisition are capable of being allocated among the various intangibles acquired.

(4) Simplifying conventions.—(i) In general. For purposes of this section, employee compensation (within the meaning of paragraph (e)(4)(ii) of this section), overhead, and de minimis costs (within the meaning of paragraph (e)(4)(iii) of this section) are treated as amounts that do not facilitate the acquisition or creation of an intangible.

(ii) Employee compensation.—(A) In general. The term ‘employee compensation’ means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For
purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(B) Certain amounts treated as employee compensation. For purposes of this section, annual compensation paid to a director of a corporation is treated as employee compensation. For example, an amount paid to a director of a corporation for attendance at a regular meeting of the board of directors (or committee thereof) is treated as employee compensation for purposes of this section. However, an amount paid to a director for attendance at a special meeting of the board of directors (or committee thereof) is not treated as employee compensation. An amount paid to a person that is not an employee of the taxpayer (including the employer of the individual who performs the services) is treated as employee compensation for purposes of this section only if the amount is paid for secretarial, clerical, or similar administrative support services. In the case of an affiliated group of corporations filing a consolidated Federal income tax return, a payment by one member of the group to a second member of the group for services performed by an employee of the second member is treated as employee compensation if the services provided by the employee are performed at a time during which both members are affiliated.

(iii) De minimis costs—(A) In general. Except as provided in paragraph (e)(4)(iii)(B) of this section, the term de minimis costs means amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction if, in the aggregate, the amounts do not exceed $5,000 (or such greater amount as may be set forth in published guidance). If the amounts exceed $5,000 (or such greater amount as may be set forth in published guidance), none of the amounts are de minimis costs within the meaning of this paragraph (e)(4)(iii)(A).

(f) Election to capitalize. A taxpayer may elect to treat employee compensation, overhead, or de minimis costs paid in the process of investigating or otherwise pursuing a transaction as amounts that facilitate the transaction. The election is made separately for each transaction and applies to employee compensation, overhead, or de minimis costs, or to any combination thereof. For example, a taxpayer may elect to treat overhead and de minimis costs, but not employee compensation, at its fair market value at the time of the payment. In determining the amount of transaction costs paid in the process of investigating or otherwise pursuing a transaction, a taxpayer generally must account for the specific costs paid with respect to each transaction. However, a taxpayer that reasonably expects to enter into at least 25 similar transactions during the taxable year may establish a pool of similar transactions for purposes of determining the amount of transaction costs paid in the process of investigating or otherwise pursuing the transactions in the pool. Under this pooling method, the amount of transaction costs paid in the process of investigating or otherwise pursuing each transaction included in the pool is equal to the average transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool. A taxpayer computes the average transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool by dividing the sum of all transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool by the number of transactions included in the pool. See paragraph (h) of this section for additional rules relating to pooling.
as amounts that facilitate the transaction. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the transaction in the taxpayer's timely filed original Federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (e)(4)(iv) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(5) Examples. The following examples illustrate the rules of this paragraph (e):

Example 1. Costs to facilitate. In December 2005, R corporation, a calendar year taxpayer, enters into negotiations with X corporation to lease commercial property from X for a period of 25 years. R pays A, its outside legal counsel, $4,000 in December 2005 for services rendered by A during December in assisting with negotiations with X. In January 2006, R and X finalize the terms of the lease and execute the lease agreement. R pays B, another of its outside legal counsel, $2,000 in January 2006 for services rendered by B during January in drafting the lease agreement. The agreement between R and X is an agreement providing R the right to use property, as described in paragraph (d)(6)(i) of this section. R’s payments to its outside counsel are amounts paid to facilitate the creation of the agreement. As provided in paragraph (e)(4)(iv) of this section, R must aggregate its transaction costs for purposes of determining whether the transaction costs are de minimis. Because R’s aggregate transaction costs exceed $5,000, R’s transaction costs are not de minimis costs within the meaning of paragraph (e)(4)(ii)(A) of this section. Accordingly, R must capitalize the $4,000 paid to A and the $2,000 paid to B under paragraph (b)(1)(v) of this section.

Example 2. Costs to facilitate. Partnership X leases its manufacturing equipment from Y corporation under a 10-year lease. During 2005, when the lease has a remaining term of 4 years, X enters into a written agreement with Z corporation, a competitor of Y, under which X agrees to lease its manufacturing equipment from Z, subject to the condition that X first successfully terminates its lease with Y. X pays Y $50,000 in exchange for Y’s agreement to terminate the equipment lease. Under paragraph (e)(1)(ii), X’s $50,000 payment does not facilitate the creation of the new lease with Z. In addition, X’s $50,000 payment does not terminate an agreement described in paragraph (d)(7) of this section. Accordingly, X is not required to capitalize the $50,000 termination payment under this section.

Example 3. Costs to facilitate. W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 5 years. W pays its outside counsel $7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. Under paragraph (e)(1)(i) of this section, W’s payment to its outside counsel is an amount paid to facilitate the creation of that agreement. As provided by paragraph (e)(2) of this section, W must capitalize its $7,000 payment to outside counsel notwithstanding the fact that W made no payment described in paragraph (d)(b)(i) of this section.

Example 4. Costs to facilitate. U corporation, which owns a majority of the common stock of T corporation, votes its controlling interest in favor of a perpetual extension of T’s charter. M, a minority shareholder in T, votes against the extension. Under applicable state law, U is required to purchase the stock of T held by M. When U and M are unable to agree on the value of M’s shares, U brings an action in state court to appraise the value of M’s stock interest. U pays attorney, accountant and appraisal fees of $25,000 for services rendered in connection with the negotiation and litigation with M. Because U’s attorney, accountant and appraisal costs, help establish the purchase price of M’s stock, U’s $25,000 payment facilitates the acquisition of stock. Accordingly, U must capitalize the $25,000 payment under paragraph (b)(1)(v) of this section.

Example 5. Costs to facilitate. For several years, H corporation has provided services to J corporation whenever requested by J. H wants to enter into a multiple-year contract with J that would give H the right to provide services to J. On June 10, 2004, H starts to prepare a bid to provide services to J and pays a consultant $15,000 to research potential competitors. On August 10, 2004, H raises the possibility of a multi-year contract with J. On October 10, 2004, H and J enter into a contract giving H the right to provide services to J for five years. During 2004, H pays $7,000 to travel to the city in which J’s offices are located to continue providing services to J under their prior arrangement and pays $6,000 for travel to the city in which J’s offices are located to further develop H’s...
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business relationship with J (for example, to introduce new employees, update J on current developments and take J’s executives to dinner). H also pays $8,000 for travel costs to meet with J to discuss and negotiate the contract. Because the contract gives H the right to provide services to J, H must capitalize amounts paid to facilitate the creation of the contract. The $7,000 of travel expenses paid to provide services to J under their prior arrangement does not facilitate the creation of the contract and is not required to be capitalized, regardless of when the travel occurs. The $6,000 of travel expenses paid to further develop H’s business relationship with J is paid in the process of pursuing the contract (and therefore must be capitalized) only to the extent the expenses relate to travel on or after June 10, 2004 (the date H begins to prepare a bid) and before October 11, 2004 (the date after H and J enter into the contract). The $8,000 of travel expenses paid to meet with J to discuss and negotiate the contract is paid in the process of pursuing the contract and must be capitalized. The $15,000 of consultant fees is paid to investigate the contract and also must be capitalized. The $8,000 of consultant fees is paid to further develop H’s business relationship with J is paid in the process of pursuing the contract (and therefore must be capitalized) only to the extent the expenses relate to travel on or after June 10, 2004 (the date H begins to prepare a bid) and before October 11, 2004 (the date after H and J enter into the contract). The $8,000 of travel expenses paid to meet with J to discuss and negotiate the contract is paid in the process of pursuing the contract and must be capitalized. The $15,000 of consultant fees is paid to investigate the contract and also must be capitalized.

Example 6. Costs that do not facilitate. X corporation brings a legal action against Y corporation to recover lost profits resulting from Y’s alleged infringement of X’s copyright. Y does not challenge X’s copyright, but argues that it did not infringe upon X’s copyright. X pays its outside counsel $25,000 for legal services rendered in pursuing the suit against Y. Because X’s title to its copyright is not in question, X’s action against Y does not involve X’s defense or perfection of title to intangible property. Thus, the amount paid to outside counsel does not facilitate the creation of an intangible described in paragraph (d)(9) of this section. Accordingly, X is not required to capitalize its $25,000 payment under this section.

Example 7. De minimis rule. W corporation, a commercial bank, acquires a portfolio containing 100 loans from Y corporation. As part of the acquisition, W pays an independent appraiser a fee of $10,000 to appraise the portfolio. The fee is an amount paid to facilitate W’s acquisition of an intangible. The acquisition of the loan portfolio is a single transaction within the meaning of paragraph (e)(3) of this section. Because the amount paid to facilitate the transaction exceeds $5,000, the amount is not de minimis as defined in paragraph (e)(4)(i)(A) of this section. Accordingly, W must capitalize the $10,000 fee under paragraph (b)(1)(v) of this section.

Example 8. Compensation and overhead. P corporation, a commercial bank, maintains a loan acquisition department whose sole function is to acquire loans from other financial institutions. As provided in paragraph (e)(4)(i) of this section, P is not required to capitalize any portion of the compensation paid to the employees in its loan acquisition department or any portion of its overhead allocable to the loan acquisition department.

(f) 12-month rule—(1) In general. Except as otherwise provided in this paragraph (f), a taxpayer is not required to capitalize under this section amounts paid to create (or to facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of—

(i) 12 months after the first date on which the taxpayer realizes the right or benefit; or

(ii) The end of the taxable year following the taxable year in which the payment is made.

(2) Duration of benefit for contract terminations. For purposes of this paragraph (f), amounts paid to terminate a contract or other agreement described in paragraph (d)(7)(i) of this section prior to its expiration date (or amounts paid to facilitate such termination) create a benefit for the taxpayer that lasts for the unexpired term of the agreement immediately before the date of the termination. If the terms of a contract or other agreement described in paragraph (d)(7)(i) of this section permit the taxpayer to terminate the contract or agreement after a notice period, amounts paid by the taxpayer to terminate the contract or agreement before the end of the notice period create a benefit for the taxpayer that lasts for the amount of time by which the notice period is shortened.

(3) Inapplicability to created financial interests and self-created amortizable section 197 intangibles. Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible described in paragraph (d)(2) of this section (relating to amounts paid to create financial interests) or to amounts paid to create (or facilitate the creation of) an intangible that constitutes an amortizable section 197 intangible within the meaning of section 197(c).

(4) Inapplicability to rights of indefinite duration. Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible of indefinite duration. A right has an indefinite duration if it has no period of duration fixed by
agreement or by law, or if it is not based on a period of time, such as a right attributable to an agreement to provide or receive a fixed amount of goods or services. For example, a license granted by a governmental agency that permits the taxpayer to operate a business conveys a right of indefinite duration if the license may be revoked only upon the taxpayer’s violation of the terms of the license.

(5) Rights subject to renewal—(i) In general. For purposes of paragraph (f)(1) of this section, the duration of a right includes any renewal period if all of the facts and circumstances in existence during the taxable year in which the right is created indicate a reasonable expectancy of renewal.

(ii) Reasonable expectancy of renewal. The following factors are significant in determining whether there exists a reasonable expectancy of renewal:

(A) Renewal history. The fact that similar rights are historically renewed is evidence of a reasonable expectancy of renewal. On the other hand, the fact that similar rights are rarely renewed is evidence of a lack of a reasonable expectancy of renewal. Where the taxpayer has no experience with similar rights, or where the taxpayer holds similar rights only occasionally, this factor is less indicative of a reasonable expectancy of renewal.

(B) Economics of the transaction. The fact that renewal is necessary for the taxpayer to earn back its investment in the right is evidence of a reasonable expectancy of renewal. For example, if a taxpayer pays $14,000 to enter into a renewable contract with an initial 9-month term that is expected to generate income to the taxpayer of $1,000 per month, the fact that renewal is necessary for the taxpayer to earn back its $14,000 payment is evidence of a reasonable expectancy of renewal.

(C) Likelihood of renewal by other party. Evidence that indicates a likelihood of renewal by the other party to a right, such as a bargain renewal option or similar arrangement, is evidence of a reasonable expectancy of renewal. However, the mere fact that the other party will have the opportunity to renew on the same terms as are available to others is not evidence of a reasonable expectancy of renewal.

(D) Terms of renewal. The fact that material terms of the right are subject to renegotiation at the end of the initial term is evidence of a lack of a reasonable expectancy of renewal. For example, if the parties to an agreement must renegotiate price or amount, the renegotiation requirement is evidence of a lack of a reasonable expectancy of renewal.

(E) Terminations. The fact that similar rights are typically terminated prior to renewal is evidence of a lack of a reasonably expectancy of renewal.

(iii) Safe harbor pooling method. In lieu of applying the reasonable expectancy of renewal test described in paragraph (f)(5)(ii) of this section to each separate right created during a taxable year, a taxpayer that reasonably expects to enter into at least 25 similar rights during the taxable year may establish a pool of similar rights for which the initial term does not extend beyond the period prescribed in paragraph (f)(1) of this section and may elect to apply the reasonable expectancy of renewal test to that pool. See paragraph (h) of this section for additional rules relating to pooling. The application of paragraph (f)(1) of this section to each pool is determined in the following manner:

(A) All amounts (except de minimis costs described in paragraph (d)(6)(v) of this section) paid to create the rights included in the pool and all amounts paid to facilitate the creation of the rights included in the pool are aggregated.

(B) If less than 20 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that does not extend beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is not required to capitalize under this section any portion of the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(C) If more than 80 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that extends
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beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is required to capitalize under this section the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(D) If 20 percent or more, but 80 percent or less, of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, the aggregate amount described in paragraph (f)(5)(iii)(A) of this section is multiplied by the percentage of the rights in the pool that are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer must capitalize the resulting amount under this section by treating such amount as creating a separate intangible. The amount determined by multiplying the aggregate amount described in paragraph (f)(5)(iii)(A) of this section by the percentage of rights in the pool that are not reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, the taxpayer must capitalize beyond the period prescribed in paragraph (f)(1) of this section, the taxpayer must capitalize the resulting amount under this section by treating such amount as creating a separate intangible. The amount determined by multiplying the aggregate amount described in paragraph (f)(5)(iii)(A) of this section by the percentage of rights in the pool that are not reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, the taxpayer must capitalize beyond the period prescribed in paragraph (f)(1) of this section, the taxpayer must capitalize the resulting amount under this section by treating such amount as creating a separate intangible.

(6) Coordination with section 461. In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See §1.461–4 for rules relating to economic performance.

(7) Election to capitalize. A taxpayer may elect not to apply the rule contained in paragraph (f)(1) of this section. An election made under this paragraph (f)(7) applies to all similar transactions during the taxable year to which paragraph (f)(1) of this section would apply (but for the election under this paragraph (f)(7)). For example, a taxpayer may elect under this paragraph (f)(7) to capitalize its costs of prepaying insurance contracts for 12 months, but may continue to apply the rule in paragraph (f)(1) to its costs of entering into non-renewable, 12-month service contracts. A taxpayer makes the election by treating the amounts as capital expenditures in its timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filling a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (f)(7) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(8) Examples. The rules of this paragraph (f) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer is a calendar year, accrual method taxpayer that does not have a short taxable year in any taxable year and has not made an election under paragraph (f)(7) of this section:

Example 1. Prepaid expenses. On December 1, 2005, N corporation pays a $10,000 insurance premium to obtain a property insurance policy (with no cash value) with a 1-year term that begins on February 1, 2006. The amount paid by N is a prepaid expense described in paragraph (d)(2) of this section, and not paragraph (d)(3) of this section. Because the right or benefit attributable to the $10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule provided by this paragraph (f) does not apply. N must capitalize the $10,000 payment.

Example 2. Prepaid expenses. (i) Assume the same facts as in Example 1, except that the policy has a term beginning on December 15, 2005. The 12-month rule of this paragraph (f) applies to the $10,000 payment because the right or benefit attributable to the payment neither extends more than 12 months beyond December 15, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, N is not required to capitalize the $10,000 payment.

(ii) Alternatively, assume N capitalizes prepaid expenses for financial accounting and reporting purposes and elects under paragraph (f)(7) of this section not to apply the 12-month rule contained in paragraph (f)(1) of this section. N must capitalize the $10,000 payment for Federal income tax purposes.

Example 2. Financial interests. On October 1, 2005, X corporation makes a 9-month loan to
Example 4. Financial interests. X corporation owns all of the outstanding stock of Z corporation. On December 1, 2005, X corporation pays $1,000,000 in exchange for Z's grant of a 9-month call option to Y permitting Y to purchase all of the outstanding stock of Z. Y's payment to X constitutes an amount paid to create or originate an option with X under paragraph (d)(2) of this section. The 9-month term of the option does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, Y must capitalize the $1,000,000 payment.

Example 5. License. (i) On July 1, 2005, R corporation pays X $10,000 in exchange for X's grant of a 9-month call option to Y permitting Y to purchase all of the outstanding stock of Z. Y's payment to X constitutes an amount paid to create or originate an option with X under paragraph (d)(2)(i)(C)(7) of this section. The 9-month term of the option does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, Y must capitalize the $1,000,000 payment.

(ii) R's payment of $10,000 is an amount paid to a governmental agency for a license granted by that agency to which paragraph (d)(5) of this section applies. Because R's payment creates rights or benefits for R that extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and beyond the end of the taxable year in which the payment is made, the rules of this paragraph (f) do not apply to R's payment. Accordingly, R must capitalize the $10,000 payment.

(iii) R's payment of each $500 annual fee is a prepaid expense described in paragraph (d)(3) of this section. R is not required to capitalize the $500 fee in each taxable year. The rules of this paragraph (f) apply to each such payment because each payment provides a right or benefit to R that does not extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and does not extend beyond the end of the taxable year following the taxable year in which the payment is made.

Example 6. Lease. On December 1, 2005, W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 9 months, beginning on December 1, 2005. W pays its outside counsel $7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The $7,000 payment to its outside counsel is an amount paid to facilitate W's creation of the lease as described in paragraph (d)(1)(A) of this section. The 12-month rule of this paragraph (f) applies to the $7,000 payment because the right or benefit that the $7,000 payment facilitates the creation of, neither extends more than 12 months beyond December 1, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, W is not required to capitalize its payment to its outside counsel.

Example 7. Certain contract terminations. V corporation owns real property that it has leased to A for a period of 15 years. When the lease has a remaining unexpired term of 5 years, V and A agree to terminate the lease, enabling V to use the property in its trade or business. V pays A $100,000 in exchange for A's agreement to terminate the lease. V's payment to A to terminate the lease is described in paragraph (d)(7)(i) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 5 years, the remaining unexpired term of the lease as of the date of the termination. Because the benefit attributable to the expenditure extends beyond 12 months after the first date on which V realizes the rights or benefits attributable to the payment and beyond the end of the taxable year following the taxable year in which the payment is made, the rules of this paragraph (f) do not apply to the payment. V must capitalize the $100,000 payment.

Example 8. Certain contract terminations. Assume the same facts as in Example 7, except that the lease is terminated when it has a remaining unexpired term of 10 months. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 10 months. The 12-month rule of this paragraph (f) applies to the payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the $100,000 payment.

Example 9. Certain contract terminations. Assume the same facts as in Example 7, except that either party can terminate the lease upon 12 months notice. When the lease has a remaining unexpired term of 5 years, V wants to terminate the lease, however, V does not want to wait another 12 months. V
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pays A $50,000 for the ability to terminate the lease with one month’s notice. V’s payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (d)(2) of this section, V’s payment creates a benefit for V with a duration of 11 months, the time by which the notice period is shortened. The 12-month rule of this paragraph (d) applies to V’s $50,000 payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the $50,000 payment.

Example 10. Coordination with section 461. (i) U corporation leases office space from W corporation at a monthly rental rate of $2,000. On August 1, 2005, U prepays its office rent expense for the first six months of 2006 in the amount of $12,000. For purposes of this example, it is assumed that the recurring item exception provided by §1.461–5 does not apply and that the lease between W and U is a section 467 rental agreement as defined in section 467(d).

(ii) Under §1.461–4(d)(3), U’s prepayment of rent is a payment for the use of property by U for which economic performance occurs ratably over the period of time U is entitled to use the property. Accordingly, because economic performance with respect to U’s prepayment of rent does not occur until 2006, U’s prepaid rent is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to U’s prepayment of its rent.

(iii) Alternatively, assume that U uses the cash method of accounting and the economic performance rules in §1.461–4 therefore do not apply to U. The 12-month rule of this paragraph (f) applies to the $12,000 payment because the rights or benefits attributable to U’s prepayment of its rent do not extend beyond December 31, 2006. Accordingly, U is not required to capitalize its prepaid rent.

Example 11. Coordination with section 461. N corporation pays R corporation, an advertising and marketing firm, $40,000 on August 1, 2005, for advertising and marketing services to be provided to N through calendar year 2006. For purposes of this example, it is assumed that the recurring item exception provided by §1.461–5 does not apply. Under §1.461–4(d)(2), N’s payment arises out of the provision of services to N by R for which economic performance occurs as the services are provided. Accordingly, because economic performance with respect to N’s prepaid advertising expense does not occur until 2006, N’s prepaid advertising expense is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to N’s payment.

(g) Treatment of capitalized costs—(1) In general. An amount required to be capitalized by this section is not currently deductible under section 162. Instead, the amount generally is added to the basis of the intangible acquired or created. See section 1012.

(2) Financial instruments. In the case of a financial instrument described in paragraph (c)(1)(iii) or (d)(2)(1)(C) of this section, notwithstanding paragraph (g)(1) of this section, if under other provisions of law the amount required to be capitalized is not required to be added to the basis of the intangible acquired or created, then the other provisions of law will govern the tax treatment of the amount.

(h) Special rules applicable to pooling—(1) In general. Except as otherwise provided, the rules of this paragraph (h) apply to the pooling methods described in paragraph (d)(6)(v) of this section (relating to de minimis rules applicable to certain contract rights), paragraph (e)(4)(iii)(A) of this section (relating to de minimis rules applicable to transaction costs), and paragraph (f)(5)(iii) of this section (relating to the application of the 12-month rule to renewable rights).

(2) Method of accounting. A pooling method authorized by this section constitutes a method of accounting for purposes of section 446. A taxpayer that adopts or changes to a pooling method authorized by this section must use the method for the year of adoption and for all subsequent taxable years during which the taxpayer qualifies to use the pooling method unless a change to another method is required by the Commissioner in order to clearly reflect income, or unless permission to change to another method is granted by the Commissioner as provided in §1.446–1(e).

(3) Adopting or changing to a pooling method. A taxpayer adopts (or changes to) a pooling method authorized by this section for any taxable year by establishing one or more pools for the taxable year in accordance with the rules governing the particular pooling method and the rules prescribed by this paragraph (h), and by using the pooling
method to compute its taxable income for the year of adoption (or change).

(4) Definition of pool. A taxpayer may use any reasonable method of defining a pool of similar transactions, agreements or rights, including a method based on the type of customer or the type of product or service provided under a contract. However, a taxpayer that pools similar transactions, agreements or rights must include in the pool all similar transactions, agreements or rights created during the taxable year. For purposes of the pooling methods described in paragraph (d)(6)(v) of this section (relating to de minimis rules applicable to certain contract rights) and paragraph (e)(4)(iii)(A) of this section (relating to de minimis rules applicable to transaction costs), an agreement (or a transaction) is treated as not similar to other agreements (or transactions) included in the pool if the amount at issue with respect to that agreement (or transaction) is reasonably expected to differ significantly from the average amount at issue with respect to the other agreements (or transactions) properly included in the pool.

(5) Consistency requirement. A taxpayer that uses the pooling method described in paragraph (f)(5)(iii) of this section for purposes of applying the 12-month rule to a right or benefit—

(i) Must use the pooling methods described in paragraph (d)(6)(v) of this section (relating to de minimis rules applicable to certain contract rights) and paragraph (e)(4)(iii)(A) of this section (relating to de minimis rules applicable to transaction costs) for purposes of determining whether its transaction costs are de minimis within the meaning of paragraph (e)(4)(iii)(A) of this section, and

(ii) Must use the same pool for purposes of paragraph (d)(6)(v) of this section and paragraph (e)(4)(iii)(A) of this section as is used for purposes of paragraph (f)(5)(iii) of this section.

(b) Additional guidance pertaining to pooling. The Internal Revenue Service may publish guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) prescribing additional rules for applying the pooling methods authorized by this section to specific industries or to specific types of transactions.

(7) Example. The following example illustrates the rules of this paragraph (h):

Example. Pooling. (i) In the course of its business, W corporation enters into 3-year non-cancelable contracts that provide W the right to provide services to its customers. W generally pays certain amounts in the process of pursuing an agreement with a customer, including amounts paid to credit reporting agencies to verify the credit history of the potential customer and commissions paid to the independent sales agent who secures the agreement with the customer. In the case of agreements that W enters into with its customers who are individuals, the agreements contain substantially similar terms and conditions. W typically pays between $100 and $200 in the process of pursuing each transaction. During 2005, W enters into agreements with 300 individuals. Also during 2005, W enters into an agreement with X corporation containing terms and conditions that are substantially similar to those contained in the agreements W enters into with its customers who are individuals. W pays certain amounts in the process of pursuing the agreement with X that W would not typically incur in the process of pursuing an agreement with its customers who are individuals. For example, W pays amounts to prepare and submit a bid for the agreement with X and amounts to travel to X’s headquarters to make a sales presentation to X’s management. In the aggregate, W pays $11,000 in the process of obtaining the agreement with X.

(ii) The agreements between W and its customers are agreements providing W the right to provide services, as described in paragraph (b)(1)(v) of this section. Under paragraph (b)(1)(v) of this section, W must capitalize transaction costs paid to facilitate the creation of these agreements. Because W enters into at least 25 similar transactions during 2005, W may pool its transactions for purposes of determining whether its transaction costs are de minimis within the meaning of paragraph (e)(4)(iii)(A) of this section. W adopts a pooling method by establishing one or more pools of similar transactions and by using the pooling method to compute its taxable income beginning in its 2005 taxable year. If W adopts a pooling method, W must include all similar transactions in the pool. Under paragraph (b)(4) of this section, the transaction with X is not similar to the transactions W enters into with its customers who are individuals. While the agreement with X contains terms and conditions that are substantially similar to those contained in the agreements W enters into with its customers who are individuals, the transaction costs paid in the process of pursuing...
the agreement with X are reasonably expected to differ significantly from the average transaction costs attributable to transactions with its customers who are individuals. Accordingly, W may not include the transaction with X in the pool of transactions with customers who are individuals.

(i) [Reserved]

(j) Application to accrual method taxpayers. For purposes of this section, the terms amount paid and payment mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of §1.146–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(k) Treatment of related parties and indirect payments. For purposes of this section, references to a party other than the taxpayer include persons related to that party and persons acting for or on behalf of that party (including persons to whom the taxpayer becomes obligated as a result of assuming a liability of that party). For this purpose, persons are related only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1). References to an amount paid to or by a party include an amount paid on behalf of that party.

(i) Examples. The rules of this section are illustrated by the following examples in which it is assumed that the Internal Revenue Service has not published guidance that requires capitalization under paragraph (b)(1)(iv) of this section (relating to amounts paid to facilitate the creation or enhancement of a future benefit that is identified in published guidance as an intangible for which capitalization is required):

Example 1. License granted by a governmental unit. (i) X corporation pays $25,000 to state R to obtain a license to sell alcoholic beverages in its restaurant. The license is valid indefinitely, provided X complies with all applicable laws regarding the sale of alcoholic beverages in state R. X pays its outside counsel $4,000 for legal services rendered in preparing the license application and otherwise representing X during the licensing process. In addition, X determines that $2,000 of salaries paid to its employees is allocable to services rendered by the employees in obtaining the license.

(ii) X’s payment of $25,000 is an amount paid to a governmental unit to obtain a license granted by that agency, as described in paragraph (d)(5)(i) of this section. The right has an indefinite duration and constitutes an amortizable section 197 intangible. Accordingly, as provided in paragraph (f)(3) of this section, the provisions of paragraph (f) of this section (relating to the 12-month rule) do not apply to X’s payment. X must capitalize its $25,000 payment to obtain the license from state R.

(iii) As provided in paragraph (e)(4) of this section, X is not required to capitalize employee compensation because such amounts are treated as amounts that do not facilitate the acquisition or creation of an intangible. Thus, X is not required to capitalize the $2,000 of employee compensation allocable to the transaction.

Example 2. Franchise agreement. (i) R corporation is a franchisor of income tax return preparation outlets. V corporation negotiates with R to obtain the right to operate an income tax return preparation outlet under a franchise from R. V pays an initial $100,000 franchise fee to R in exchange for the franchise agreement. In addition, V pays its outside counsel $4,000 to represent V during the negotiations with R. V also pays $2,000 to an industry consultant to advise V during the negotiations with R.

(ii) Under paragraph (d)(6)(i)(A) of this section, V’s payment of $100,000 is an amount paid to another party to enter into an agreement with that party providing V the right to use tangible or intangible property. Accordingly, V must capitalize its $100,000 payment to R. The franchise agreement is a self-created amortizable section 197 intangible within the meaning of section 197(c). Accordingly, as provided in paragraph (f)(3) of this section, the 12-month rule contained in paragraph (f)(1) of this section does not apply.

(iii) V’s payment of $4,000 to its outside counsel and $2,000 to the industry consultant are amounts paid to facilitate the creation of an intangible, as described in paragraph (e)(4)(iii)(A) of this section. Because V’s aggregate transaction costs exceed $5,000, V’s transaction costs are not de minimis within the meaning of paragraph (e)(4)(iii)(A) of this section. Accordingly, V must capitalize the $4,000 payment to its outside counsel and the $2,000 payment to the industry consultant.
under this section into the basis of the franchise, as provided in paragraph (g) of this section.

Example 3. Covenant not to compete. (i) On December 1, 2005, a calendar-year taxpayer, enters into a covenant not to compete with B, a key employee that is leaving the employ of N. The covenant not to compete entered into in connection with the acquisition of interest in a trade or business. The covenant not to compete prohibits B from competing with N for a period of 9 months, beginning December 1, 2005. N pays B $25,000 in full consideration for B’s agreement not to compete. In addition, N pays its outside counsel $6,000 to facilitate the creation of the covenant not to compete with B. N does not have a short taxable year in 2005 or 2006.

(ii) Under paragraph (d)(6)(i)(C) of this section, N’s payment of $25,000 is an amount paid to another party to induce that party to enter into a covenant not to compete with N. However, because the covenant not to compete has a duration that does not extend beyond 12 months after the first date on which N realizes the rights attributable to its payment (i.e., December 1, 2006) or beyond the end of the taxable year following the taxable year in which payment is made, the 12-month rule contained in paragraph (f)(1) of this section applies. Accordingly, N is not required to capitalize its $25,000 payment to B or its $6,000 payment to facilitate the creation of the covenant not to compete with B.

Example 4. Demand-side management. (i) X corporation, a public utility engaged in generating and distributing electrical energy, provides programs to its customers to promote energy conservation and energy efficiency. These programs are aimed at reducing electrical costs to X’s customers, building goodwill with X’s customers, and reducing X’s future operating and capital costs. X provides these programs without obligating any of its customers participating in the programs to purchase power from X in the future. Under these programs, X pays a consultant to help industrial customers design energy-efficient manufacturing processes, to conduct “energy-efficiency audits” that serve to identify for customers inefficiencies in their energy usage patterns, and to provide cash allowances to encourage residential customers to replace existing appliances with more energy efficient appliances.

(ii) The amounts paid by X to the consultant are not amounts to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to the consultant are not required to be capitalized under this section. While the amounts may serve to reduce future operating and capital costs and create goodwill with customers, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 5. Business process re-engineering. (i) V corporation manufactures its products using a batch production system. Under this system, V continuously produces component parts of its various products and stockpiles these parts until they are needed in V’s final assembly line. Finished goods are stockpiled awaiting orders from customers. V discovers that this process ties up significant amounts of V’s capital in work-in-process and finished goods inventories. V hires B, a consultant, to advise V on improving the efficiency of its manufacturing operations. B recommends a complete re-engineering of V’s manufacturing process to a process known as just-in-time manufacturing. Just-in-time manufacturing involves reconfiguring a manufacturing plant to a configuration of “cells” where each team in a cell performs the entire manufacturing process for a particular customer order, thus reducing inventory stockpiles.

(ii) V incurred three categories of costs to convert its manufacturing process to a just-in-time system. First, V paid B, a consultant, $250,000 in professional fees to implement the conversion of V’s plant to a just-in-time system. Second, V paid C, a contractor, $100,000 to relocate and reconfigure V’s manufacturing equipment from an assembly line layout to a configuration of cells. Third, V paid D, a consultant, $50,000 to train V’s employees in the just-in-time manufacturing process.

(iii) The amounts paid by V to B, C, and D are not amounts to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to B, C, and D are not required to be capitalized under this section. While the amounts produce long term benefits to V in the form of reduced inventory stockpiles, improved product quality, and increased efficiency, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 6. Defense of business reputation. (i) X, an investment adviser, serves as the fund manager of a money market investment fund. X, like its competitors in the industry, strives to maintain a constant net asset value for its money market fund of $1.00 per share. During 2005, in the course of managing the fund assets, X incorrectly predicts the direction of market interest rates, resulting in significant investment losses to the fund. Due to these significant losses, X is faced with the prospect of reporting a net asset value that is less than $1.00 per share. X is
not aware of any investment adviser in its industry that has ever reported a net asset value for its money market fund of less than $1.00 per share. X is concerned that reporting a net asset value less than $1.00 per share will significantly harm its reputation as an investment adviser, and could lead to litigation by shareholders. X decides to contribute $2,000,000 to the fund in order to raise the net asset value of the fund to $1.00 per share. This contribution is not a loan to the fund and does not give X any ownership interest in the fund.

(ii) The $2,000,000 contribution is not an amount paid to acquire or create an intangible asset within the meaning of paragraph (b)(3)(v) of this section or to facilitate such an acquisition or creation. In addition, the amount does not create a separate and distinct intangible asset. Accordingly, the amount contributed to the fund is not required to be capitalized. While the amount serves to protect the business reputation of the taxpayer and may protect the taxpayer from litigation by shareholders, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 7. Product launch costs. (i) R corporation, a manufacturer of pharmaceutical products, is required by law to obtain regulatory approval before selling its products. While awaiting regulatory approval on Product A, R pays to develop and implement a marketing strategy and an advertising campaign to raise consumer awareness of the purported need for Product A. R also pays to train health care professionals and other distributors in the proper use of Product A.

(ii) The amounts paid by R are not amounts paid to acquire or create an intangible asset within the meaning of paragraph (b)(3)(v) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset. Accordingly, R is not required to capitalize these amounts under this section. While the amounts may benefit R by creating consumer demand for Product A and increasing awareness of Product A among distributors, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 8. Stocklifting costs. (i) N corporation is a whole sale distributor of Brand A aftermarket automobile replacement parts. In an effort to induce a retail automobile parts supply store to stock only Brand A parts, N offers to replace all of the store’s inventory of other branded parts with Brand A parts, and to credit the store for its cost of other branded parts. The store is under no obligation to continue stocking Brand A parts or to purchase a minimum volume of Brand A parts from N in the future.

(ii) The amount paid by N as a credit to the store for the cost of other branded parts is not an amount paid to acquire or create an intangible asset within the meaning of paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amount does not create a separate and distinct intangible asset. Accordingly, N is not required to capitalize the amount under this section. While the amount may create a hope or expectation by N that the store will continue to stock Brand A parts, this benefit, without more, is not an intangible for which capitalization is required under this section.

(iii) Alternatively, assume that N agrees to credit the store for its cost of other branded parts in exchange for the store’s agreement to purchase all of its inventory requirements for such parts from N for a period of at least 3 years. The amount paid by N as a credit to the store for the cost of other branded parts is an amount paid to induce the store to enter into an agreement providing R the right to provide property. Accordingly, R must capitalize its payment.

Example 9. Package design costs. (i) Z corporation manufactures and markets personal care products. Z pays $100,000 to a consultant to develop a package design for Z’s newest product, Product A. Z also pays a fee to a government agency to obtain trademark and copyright protection on certain elements of the package design. Z pays its outside legal counsel $10,000 for services rendered in preparing and filing the trademark and copyright applications and for other services rendered in securing the trademark and copyright protection.

(ii) The $100,000 paid by Z to the consultant for development of the package design is not an amount paid to acquire or create an intangible asset within the meaning of paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, as provided in paragraph (b)(3)(v) of this section, amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset. Accordingly, Z is not required to capitalize the $100,000 payment under this section.

(iii) The amounts paid by Z to the government agency to obtain trademark and copyright protection are amounts paid to a government agency for a right granted by that agency. Accordingly, Z must capitalize the payment. In addition, the $10,000 paid by Z to its outside counsel is an amount paid to facilitate the creation of the trademark and copyright. Because the aggregate amounts paid to facilitate the transaction exceed $5,000, the amounts are not de minimis as defined in paragraph (e)(4)(iii)(A) of this section. Accordingly, Z must capitalize the $10,000 payment to its outside counsel under paragraph (b)(1)(v) of this section.
(iv) Alternatively, assume that Z acquires an existing package design for Product A as part of an acquisition of a trade or business that constitutes an applicable asset acquisition, as defined in section 1060(c). Assume further that $100,000 of the consideration paid by N in the acquisition is properly allocable to the package design for Product A. Under paragraph (c)(1) of this section, Z must capitalize the $100,000 payment.

Example 19. Contract to provide services. (i) Q corporation, a financial planning firm, provides financial advisory services on a fee-only basis. During 2005, Q and several other financial planning firms submit separate bids to R corporation for a contract to become one of three providers of financial advisory services to R’s employees. Q pays $2,000 to a printing company to develop and produce materials for its sales presentation to R’s management. Q also pays $6,000 to travel to R’s corporate headquarters to make the sales presentation, and $20,000 of salaries to its employees for services performed in preparing the bid and making the presentation to R’s management. Q’s bid is successful and Q enters into an agreement with R in 2005 under which Q agrees to provide financial advisory services to R’s employees, and R agrees to pay Q’s fee on behalf of each employee who chooses to utilize such services. R enters into similar agreements with two other financial planning firms, and R’s employees may choose to use the services of any one of the three firms. Based on its past experience, Q reasonably expects to provide services to at least 5 percent of R’s employees.

(ii) Q’s agreement with R is not an agreement providing Q the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Under paragraph (d)(6)(iv) the agreement places no obligation on another person to request or pay for Q’s services. Accordingly, Q is not required to capitalize any of the amounts paid in the process of pursuing the agreement with R.

Example II. Mutual fund distributor. (i) D incurs costs to enter into a distribution agreement with M, a mutual fund. The initial term of the distribution agreement is two years, and afterwards must be approved annually by M. The distribution agreement can be terminated by either party on 60 days notice. Although distribution agreements are rarely terminated in the mutual fund industry, M is not economically compelled to continue D’s distribution agreement. Under the distribution agreement, D has the exclusive right to sell shares of M and agrees to use its best efforts to solicit orders for the sale of shares of M. D sells shares in M directly to the general public as well as through brokers. When an investor places an order for M shares with a broker, D pays the broker a commission for selling the shares to the investor. Under the distribution agreement, D receives compensation from M in the form of 12b-1 fees (which equal a percentage of M’s net asset value attributable to investors that have held their shares for up to 6 years) and contingent deferred sales charges (which are paid if the investor redeems the purchased shares within 6 years).

(ii) The distribution agreement is not an agreement providing D with the right to provide services, as described in paragraph (d)(6)(i)(B) of this section, because the distribution agreement can be terminated by M at will upon 60 days notice and M is not economically compelled to continue the distribution agreement. Accordingly, D is not required to capitalize the costs of creating (or facilitating the creation of) the distribution agreement under paragraphs (b)(1)(iii) or (v) of this section. In addition, as provided in paragraph (b)(3)(ii) of this section, amounts paid to create an agreement are treated as amounts that do not create a separate and distinct intangible asset. Accordingly, D also is not required to capitalize the costs of creating (or facilitating the creation of) the distribution agreement under paragraph (b)(1)(iii) or (v) of this section.

(iii) Under paragraph (b)(3)(iii), the broker commissions paid by D in performing services under the distribution agreement do not create (or facilitate the creation of) a separate and distinct intangible asset. In addition, the broker commissions do not create an intangible described in paragraph (d) of this section. Accordingly, D is not required to capitalize the broker commissions under this section.

(m) Amortization. For rules relating to amortization of certain intangibles, see §1.167(a)-3.

(n) Intangible interests in land. [Reserved]

(o) Effective date. This section applies to amounts paid or incurred on or after December 31, 2003.

(p) Accounting method changes—(1) In general. A taxpayer seeking to change a method of accounting to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446-1(e). For the taxpayer’s first taxable year ending on or after December 31, 2003, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with this section, provided the taxpayer follows the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner’s automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-
(2) Scope limitations. Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003.

(3) Section 481(a) adjustment. With the exception of a change to a pooling method authorized by this section, the section 481(a) adjustment for a change in method of accounting to comply with this section for a taxpayer’s first taxable year ending on or after December 31, 2003 is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002. A taxpayer seeking to change to a pooling method authorized by this section on or after the effective date of these regulations must change to the method using a cut-off method.

[T.D. 9107, 69 FR 446, Jan. 5, 2004]

§ 1.263(a)–5 Amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions.

(a) General rule. A taxpayer must capitalize an amount paid to facilitate (within the meaning of paragraph (b) of this section) each of the following transactions, without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction:

(1) An acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition).

(2) An acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b) or 707(b) (see §1.263(a)–4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, where the taxpayer and the business entity are not related within the meaning of section 267(b) or 707(b) immediately after the acquisition).

(3) An acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise).

(4) A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in section 368 and distributions of stock by the taxpayer as described in section 355).

(5) A transfer described in section 351 or section 721 (whether the taxpayer is the transferor or transferee).

(6) A formation or organization of a disregarded entity.

(7) An acquisition of capital.

(8) A stock issuance.

(9) A borrowing. For purposes of this section, a borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization. A borrowing also includes debt issued in a debt for debt exchange under §1.1001–3.

(10) Writing an option.

(b) Scope of facilitate—(1) In general. Except as otherwise provided in this section, an amount is paid to facilitate a transaction described in paragraph (a) of this section if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange. For example, the purchase price paid to the target of an asset acquisition in exchange for its assets is not an amount paid to facilitate the acquisition. Similarly, the purchase price paid by an acquirer to the target’s shareholders in
exchange for their stock in a stock acquisition is not an amount paid to facilitate the acquisition of the stock. See §1.263(a)–1, §1.263(a)–2, and §1.263(a)–4 for rules requiring capitalization of the purchase price paid to acquire property.

(2) Ordering rules. An amount paid in the process of investigating or otherwise pursuing both a transaction described in paragraph (a) of this section and an acquisition or creation of an intangible described in §1.263(a)–4 is subject to the rules contained in this section, and not to the rules contained in §1.263(a)–4. In addition, an amount required to be capitalized by §1.263(a)–1, §1.263(a)–2, or §1.263(a)–4 does not facilitate a transaction described in paragraph (a) of this section.

(c) Special rules for certain costs—(1) Borrowing costs. An amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing) described in paragraph (a) of this section. For example, where a target corporation, in preparation for a merger with an acquiring corporation, sells assets that are not desired by the acquiring corporation, amounts paid to facilitate the sale of the unwanted assets are not required to be capitalized as amounts paid to facilitate the merger.

(2) Costs of asset sales. An amount paid by a taxpayer to facilitate a sale of its assets does not facilitate another transaction (other than the sale) described in paragraph (a) of this section. For example, where a target corporation, in preparation for a merger with an acquiring corporation, sells assets that are not desired by the acquiring corporation, amounts paid to facilitate the sale of the unwanted assets are not required to be capitalized as amounts paid to facilitate the merger.

(3) Mandatory stock distributions. An amount paid in the process of investigating or otherwise pursuing a distribution of stock by a taxpayer to its shareholders does not facilitate a transaction described in paragraph (a) of this section if the divestiture of the stock (or of properties transferred to an entity whose stock is distributed) is required by law, regulatory mandate, or court order. A taxpayer is not required to capitalize (under this section or §1.263(a)–4) an amount paid to organize (or facilitate the organization of) an entity if the entity is organized solely to receive properties that the taxpayer is required to divest by law, regulatory mandate, or court order and if the taxpayer distributes the stock of the entity to its shareholders. A taxpayer also is not required to capitalize (under this section or §1.263(a)–4) an amount paid to transfer property to an entity if the taxpayer is required to divest itself of that property by law, regulatory mandate, or court order and if the stock of the recipient entity is distributed to the taxpayer’s shareholders.

(4) Bankruptcy reorganization costs. An amount paid to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code by a taxpayer that is the debtor under the proceeding constitutes an amount paid to facilitate a reorganization within the meaning of paragraph (a)(4) of this section, regardless of the purpose for which the proceeding is instituted. For example, an amount paid to prepare and file a petition under Chapter 11 to obtain an extension of the exclusivity period under Chapter 11, to formulate plans of reorganization under Chapter 11, to analyze plans of reorganization formulated by another party in interest, or to contest or obtain approval of a plan of reorganization under Chapter 11 facilitates a reorganization within the meaning of this section. However, amounts specifically paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization under Chapter 11 that resolves tort liabilities of the taxpayer do not facilitate a reorganization within the meaning of paragraph (a)(4) of this section if the amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. In addition, an amount paid by the taxpayer to defend against the commencement of an involuntary bankruptcy proceeding against the taxpayer does not facilitate a reorganization within the meaning of paragraph (a)(4) of this section. An amount paid by the debtor to operate its business during a Chapter 11 bankruptcy proceeding is not an amount paid to institute or administer the bankruptcy proceeding and does not facilitate a reorganization. Such amount is treated in the same manner as it would have been treated had the bankruptcy proceeding not been instituted.

(5) Stock issuance costs of open-end regulated investment companies. Amounts
paid by an open-end regulated investment company (within the meaning of section 851) to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section unless the amounts are paid during the initial stock offering period.

(6) Integration costs. An amount paid to integrate the business operations of the taxpayer with the business operations of another does not facilitate a transaction described in paragraph (a) of this section, regardless of when the integration activities occur.

(7) Registrar and transfer agent fees for the maintenance of capital stock records. An amount paid by a taxpayer to a registrar or transfer agent in connection with the transfer of the taxpayer’s capital stock does not facilitate a transaction described in paragraph (a) of this section unless the amount is paid with respect to a specific transaction described in paragraph (a). For example, a taxpayer is not required to capitalize periodic payments to a transfer agent for maintaining records of the names and addresses of shareholders who trade the taxpayer’s shares on a national exchange. By comparison, a taxpayer is required to capitalize an amount paid to the transfer agent for distributing proxy statements requesting shareholder approval of a transaction described in paragraph (a) of this section.

(8) Termination payments and amounts paid to facilitate mutually exclusive transactions. An amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction described in paragraph (a) of this section constitutes an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive. An amount paid to facilitate a transaction described in paragraph (a) of this section is treated as an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive.

(d) Simplifying conventions—(1) In general. For purposes of this section, employee compensation (within the meaning of paragraph (d)(2) of this section), overhead, and de minimis costs (within the meaning of paragraph (d)(3) of this section) are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section.

(2) Employee compensation—(i) In general. The term employee compensation means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(ii) Certain amounts treated as employee compensation. For purposes of this section, a guaranteed payment to a partner in a partnership is treated as employee compensation. For purposes of this section, annual compensation paid to a director of a corporation is treated as employee compensation. For example, an amount paid to a director of a corporation for attendance at a regular meeting of the board of directors (or committee thereof) is treated as employee compensation for purposes of this section. However, an amount paid to the director for attendance at a special meeting of the board of directors (or committee thereof) is not treated as employee compensation. An amount paid to a person that is not an employee of the taxpayer (including the employer of the individual who performs the services) is treated as employee compensation for purposes of this section only if the amount is paid for secretarial, clerical, or similar administrative support services (other than services involving the preparation and distribution of proxy solicitations and other documents seeking shareholder approval of a transaction described in paragraph (a) of this section). In the case of an affiliated group of corporations filing a consolidated federal income tax return, a payment by one member of the group to a second member of the group for services performed by an employee of the second member is treated as employee compensation if the services provided by the employee are provided at a time during which both members are affiliated.

(3) De minimis costs—(i) In general. The term de minimis costs means
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amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a) of this section if, in the aggregate, the amounts do not exceed $5,000 (or such greater amount as may be set forth in published guidance). If the amounts exceed $5,000 (or such greater amount as may be set forth in published guidance), none of the amounts are de minimis costs within the meaning of this paragraph (d)(3). For purposes of this paragraph (d)(3), an amount paid in the form of property is valued at its fair market value at the time of the payment.

(ii) Treatment of commissions. The term de minimis costs does not include commissions paid to facilitate a transaction described in paragraph (a) of this section.

(4) Election to capitalize. A taxpayer may elect to treat employee compensation, overhead, or de minimis costs paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a) of this section as amounts that facilitate the transaction. The election is made separately for each transaction and applies to employee compensation, overhead, or de minimis costs, or to any combination thereof. For example, a taxpayer may elect to treat overhead and de minimis costs, but not employee compensation, as amounts that facilitate the transaction. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the transaction in the taxpayer’s timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (d)(4) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(e) Certain acquisitive transactions—(1) In general. Except as provided in paragraph (e)(2) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction (as described in paragraph (e)(3) of this section) facilitates the transaction within the meaning of this section only if the amount relates to activities performed on or after the earlier of—

(i) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or

(ii) The date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer’s board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer’s board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) the date determined under this paragraph (e)(1)(ii) is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.

(2) Exception for inherently facilitative amounts. An amount paid in the process of investigating or otherwise pursuing a covered transaction facilitates that transaction if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined under paragraph (e)(1) of this section. An amount is inherently facilitative if the amount is paid for—

(i) Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;

(ii) Structuring the transaction, including negotiating the structure of
the transaction and obtaining tax advice on the structure of the transaction (for example, obtaining tax advice on the application of section 368); (iii) Preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement); (iv) Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings; (v) Obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or (vi) Conveying property between the parties to the transaction (for example, transfer taxes and title registration costs).

(3) Covered transactions. For purposes of this paragraph (e), the term covered transaction means the following transactions:

(i) A taxable acquisition by the taxpayer of assets that constitute a trade or business.
(ii) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b).
(iii) A reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

(f) Documentation of success-based fees—An amount paid that is contingent on the successful closing of a transaction described in paragraph (a) of this section is an amount paid to facilitate the transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. This documentation must be completed on or before the due date of the taxpayer’s timely filed original federal income tax return (including extensions) for the taxable year during which the transaction closes. For purposes of this paragraph (f), documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and must consist of supporting records (for example, time records, itemized invoices, or other records) that identify—

(1) The various activities performed by the service provider;
(2) The amount of the fee (or percentage of time) that is allocable to each of the various activities performed;
(3) Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and
(4) The name, business address, and business telephone number of the service provider.

(g) Treatment of capitalized costs—(1) Tax-free acquisitive transactions.

(2) Taxable acquisitive transactions—(i) Acquirer. In the case of an acquisition, merger, or consolidation that is not described in section 368, an amount required to be capitalized under this section by the acquirer is added to the basis of the acquired assets (in the case of a transaction that is treated as an acquisition of the assets of the target for federal income tax purposes) or the acquired stock (in the case of a transaction that is treated as an acquisition of the stock of the target for federal income tax purposes).

(ii) Target—(A) Asset acquisition. In the case of an acquisition, merger, or consolidation that is not described in section 368, an amount required to be capitalized under this section by the target is treated as a reduction of the target’s amount realized on the disposition of its assets.

(B) Stock acquisition. [Reserved]

(3) Stock issuance transactions. [Reserved]

(4) Borrowings. For the treatment of amounts required to be capitalized
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under this section with respect to a borrowing, see §1.446-5.

(5) Treatment of capitalized amounts by option writer. An amount required to be capitalized by an option writer under paragraph (a)(10) of this section is not currently deductible under section 162 or 212. Instead, the amount required to be capitalized generally reduces the total premium received by the option writer. However, other provisions of law may limit the reduction of the premium by the capitalized amount (for example, if the capitalized amount is never deductible by the option writer).

(h) Application to accrual method taxpayers. For purposes of this section, the terms amount paid and payment mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of §1.446–1(c)(1)(i)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(i) [Reserved]
(j) Coordination with other provisions of the Internal Revenue Code. Nothing in this section changes the treatment of an amount that is specifically provided for under any other provision of the Internal Revenue Code (other than section 162(a) or 212) or regulations thereunder.

(k) Treatment of indirect payments. For purposes of this section, references to an amount paid to or by a party include an amount paid on behalf of that party.

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

Example 1. Costs to facilitate. Q corporation pays its outside counsel $20,000 to assist Q in registering its stock with the Securities and Exchange Commission. Q is not a regulated investment company within the meaning of section 851. Q’s payments to its outside counsel are amounts paid to facilitate the issuance of stock. Accordingly, Q must capitalize its $20,000 payment under paragraph (a)(8) of this section (whether incurred before or after the issuance of the stock and whether or not the registration is productive of equity capital).

Example 2. Costs to facilitate. Q corporation seeks to acquire all of the outstanding stock of Y corporation. To finance the acquisition, Q must issue new debt. Q pays an investment banker $25,000 to market the debt to the public and pays its outside counsel $10,000 to prepare the offering documents for the debt. Q’s payment of $35,000 facilitates a borrowing and must be capitalized under paragraph (a)(9) of this section. As provided in paragraph (c)(1) of this section, Q’s payment does not facilitate the acquisition of Y. Standing the fact that Q incurred the new debt, the borrowing must be capitalized under paragraph (a)(9) of this section. Accordingly, Q must capitalize the $250,000 payment to B. See §1.446-5 for the treatment of Q’s capitalized payment.

Example 3. Costs to facilitate. (i) Z agrees to pay investment banker B $1,000,000 for B’s services in evaluating four alternative transactions ($250,000 for each alternative): An initial public offering; a borrowing of funds; an acquisition of Z by a competitor; and an acquisition of Z by a competitor. Z eventually decides to pursue a borrowing and abandons the other options.

(ii) The $250,000 payment to evaluate the possibility of a borrowing is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(8) of this section. Accordingly Z must capitalize that $250,000 payment to B. See §1.446-5 for the treatment of Z’s capitalized payment.

(iii) The $250,000 payment to evaluate the possibility of an initial public offering is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(9) of this section. Accordingly Z must capitalize that $250,000 payment to B. See §1.446-5 for the treatment of Z’s capitalized payment.

(iv) The $500,000 payment by Z to evaluate the possibilities of an acquisition of Z by a competitor and an acquisition of a competitor by Z are amounts paid in the process of investigating or otherwise pursuing transactions described in paragraphs (a) and (e)(3) of this section. Accordingly, Z is only required to capitalize under this section the portion of the $500,000 payment that relates to inherently facilitative activities under paragraph (e)(2) of this section or to activities performed on or after the date determined under paragraph (e)(1) of this section. Because the borrowing and the possible acquisitions are not mutually exclusive transactions, no portion of the $500,000 is treated as an amount paid to facilitate the borrowing. When Z abandons the initial public offering, Z may recover under section 165 the $250,000 paid to facilitate the initial public offering.

(v) The $500,000 paid by Z to evaluate the possibility of an acquisition of Z by a competitor and an acquisition of a competitor by Z are amounts paid in the process of investigating or otherwise pursuing transactions described in paragraphs (a) and (e)(3) of this section. Accordingly, Z is only required to capitalize under this section the portion of the $500,000 payment that relates to inherently facilitative activities under paragraph (e)(2) of this section or to activities performed on or after the date determined under paragraph (e)(1) of this section. Because the borrowing and the possible acquisitions are not mutually exclusive transactions, no portion of the $500,000 is treated as an amount paid to facilitate the borrowing. When Z abandons the initial public offering, Z may recover under section 165 any portion of the $500,000 that was paid to facilitate the acquisitions.

Example 4. Corporate acquisition. (i) On February 1, 2005, R corporation decides to investigate the acquisition of three potential targets: T corporation, U corporation, and V corporation. R’s consideration of T, U, and V represents the consideration of three distinct
transactions, any or all of which R might consummate and has the financial ability to consummate. On March 1, 2005, R enters into an exclusivity agreement with T and stops pursuing U and V. On July 1, 2005, R acquires all of the stock of T in a transaction described in section 368. R pays $1,000,000 to an investment banker and $50,000 to its outside counsel to conduct due diligence on T, U, and V; determine the value of T, U, and V; negotiate and structure the transaction with T; draft the merger agreement; secure shareholder approval; prepare SEC filings; and obtain the necessary regulatory approvals.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on T, U and V prior to March 1, 2005 (the date of the exclusivity agreement) are not amounts paid to facilitate the acquisition of the stock of T, U or V and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on T on and after March 1, 2005, are amounts paid to facilitate the acquisition of the stock of T and must be capitalized under paragraph (a)(2) of this section.

(iii) Under paragraph (e)(2) of this section, the amounts paid to conduct due diligence, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain necessary regulatory approvals are inherently facilitative amounts paid to facilitate the acquisition of the stock of T and must be capitalized, regardless of whether those activities occur prior to, on, or after March 1, 2005.

(iv) Under paragraph (e)(2) of this section, the amounts paid to determine the value of U and V are inherently facilitative amounts paid to facilitate the acquisition of U or V and must be capitalized. Because the acquisition of U, V, and T are not mutually exclusive transactions, the costs that facilitate the acquisition of U and V do not facilitate the acquisition of T. Accordingly, the amounts paid to determine the value of U and V may be recovered under section 165 in the taxable year that R abandons the planned mergers with U and V.

Example 5. Corporate acquisition; employee bonus. Assume the same facts as in Example 4, except R pays a bonus of $10,000 to one of its corporate officers who negotiated the acquisition of T. As provided by paragraph (d)(1) of this section, Y is not required to capitalize any portion of the bonus paid to the corporate officer.

Example 6. Corporate acquisition; integration costs. Assume the same facts as in Example 4, except that, before and after the acquisition is consummated, R incurs costs to relocate personnel and equipment, provide severance benefits to terminated employees, integrate records and information systems, prepare new financial statements for the combined entity, and reduce redundancies in the combined business operations. Under paragraph (c)(6) of this section, these costs do not facilitate the acquisition of T. Accordingly, R is not required to capitalize any of these costs under this section.

Example 7. Corporate acquisition; compensation to target’s employees. Assume the same facts as in Example 4, except that, prior to the acquisition, certain employees of Y were granted unexercised options issued pursuant to T’s stock option plan. These options granted the employees the right to purchase T stock at a fixed option price. The options did not have a readily ascertainable value (within the meaning of §1.83–7(b)), and thus no amount was included in the employees’ income when the options were granted. As a condition of the acquisition, T is required to terminate its stock option plan. T therefore agrees to pay its employees who held unexercised options. Under paragraph (d)(1) of this section, T is not required to capitalize the amounts paid to its employees. See section 83 for the treatment of amounts received in cancellation of stock options.

Example 8. Asset acquisition; employee compensation. N corporation owns tangible and intangible assets that constitute a trade or business. M corporation purchases all the assets of N in a taxable transaction. Under paragraph (a)(1) of this section, M must capitalize amounts paid to facilitate the acquisition of the assets of N. Under paragraph (d)(1) of this section, no portion of the salary of M’s employees who work on the acquisition are treated as facilitating the transaction.

Example 9. Corporate acquisition; retainer. Y corporation’s outside counsel charges Y $80,000 for services rendered in facilitating the friendly acquisition of the stock of Y corporation by X corporation. Y has an agreement with its outside counsel under which Y pays an annual retainer of $50,000. Y’s outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y’s outside counsel offsets $50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of $30,000. The $50,000 legal fee is an amount paid to facilitate the acquisition of an ownership interest in Y as described in paragraph (a)(3) of this section. Y must capitalize the full amount of the $80,000 legal fee.

Example 10. Corporate acquisition; antitrust defense costs. On March 1, 2005, V corporation enters into an agreement with X corporation to acquire all of the outstanding stock of X. On April 1, 2005, federal and state regulators file suit against V to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. V enters into a consent
agreement with regulators on May 1, 2005, that allows the acquisition to proceed, but requires V to hold separate the business operations of X pending the outcome of the antitrust suit and subjects V to possible divestiture. V acquires title to all of the outstanding stock of X on June 1, 2005. After June 1, 2005, the regulators pursue antitrust litigation against V seeking rescission of the acquisition. V pays $50,000 to its outside counsel for services rendered after June 1, 2005, to defend against the antitrust litigation. V's costs to defend the antitrust litigation are costs to facilitate its acquisition of the stock of X under paragraph (a)(2) of this section and must be capitalized. Although title to the shares of X passed to V prior to the date V incurred costs to defend the antitrust litigation, the amounts paid by V are paid in the process of pursuing the acquisition of the stock of X because the acquisition was not complete until the antitrust litigation was ultimately resolved. V must capitalize the $50,000 in legal fees.

Example 11. Corporate acquisition; defensive measures. (i) On January 15, 2005, Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential "white knight" acquirer. Y also pays amounts to complete a defensive recapitalization, and pays $50,000 to an investment banker for a fairness opinion regarding Z’s initial offer. Y’s efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2005, Y’s board of directors decides to abandon its defense against the takeover and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its defense against the takeover, Y pays an investment banker $1,000,000 for a second fairness opinion and for services rendered in negotiating with Z.

(ii) The legal fees paid by Y to seek an injunction against the takeover are not amounts paid in the process of investigating or otherwise pursuing the transaction with Z. Accordingly, these legal fees are not required to be capitalized under this section.

(iii) The investment banking fees paid by Y to seek an injunction against the takeover are not amounts paid in the process of investigating or otherwise pursuing the transaction with Z. Accordingly, these investment banking fees are not required to be capitalized under this section.

(iv) The amounts paid by Y to investigate and complete the recapitalization must be capitalized under paragraph (a)(4) of this section.

(v) The $50,000 paid to the investment bankers for a fairness opinion during Y’s defense against the takeover and the $1,000,000 paid to the investment bankers after Y abandons its defense against the takeover are inherently facilitative amounts with respect to the transaction with Z and must be capitalized under paragraph (a)(3) of this section.

Example 12. Corporate acquisition; acquisition by white knight. (i) Assume the same facts as in Example 11, except that Y’s investment bankers identify three potential white knight acquirers: U corporation, V corporation, and W corporation. Y pays its investment bankers to conduct due diligence on the three potential white knight acquirers. On March 15, 2005, Y’s board of directors approves a tentative acquisition agreement under which W agrees to acquire all of the stock of Y, and the investment bankers stop due diligence on U and V. On June 15, 2005, W acquires all of the stock of Y.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on U, V, and W prior to March 15, 2005 (the date of board of directors’ approval) are not amounts paid to facilitate the acquisition of the stock of Y and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on W on and after March 15, 2005, facilitate the acquisition of the stock of Y and are required to be capitalized.

Example 13. Corporate acquisition; mutually exclusive costs. (i) Assume the same facts as in Example 11, except that Y’s investment banker finds W, a white knight. Y and W execute a letter of intent on March 10, 2005. Under the terms of the letter of intent, Y must pay W a $10,000,000 break-up fee if the merger with W does not occur. On April 1, 2005, Z significantly increases the amount of its offer, and Y decides to accept Z’s offer instead of merging with W. Y pays its investment banker $500,000 for due diligence costs with respect to the potential merger with W. Y also pays its investment banker $2,000,000 for due diligence costs with respect to the potential merger with W of which relates to services performed on or after March 10, 2005.

(ii) Y’s $500,000 payment for inherently facilitative costs and Y’s $1,000,000 payment for due diligence activities performed on or after March 10, 2005 (the date the letter of intent with W is entered into) facilitate the potential merger with W. Because Y could not merge with both W and Z, under paragraph (c)(8) of this section the $500,000 and $1,000,000 payments also facilitate the transaction between Y and Z. Accordingly, Y must capitalize the $500,000 and $1,000,000 payments as amounts that facilitate the transaction with Z.
Example 14. Break-up fee; transactions not mutually exclusive. N corporation and U corporation enter into an agreement under which U would acquire all the stock or all of the assets of N in exchange for U stock. Under the terms of the agreement, if either party terminates the agreement, the terminating party must pay the other party $10,000,000. Shortly thereafter, U acquires all the stock of V corporation, a competitor of N. U had the financial resources to have acquired both N and V. U’s $10,000,000 payment does not facilitate U’s acquisition of V. Accordingly, U is not required to capitalize the $10,000,000 payment under this section.

Example 15. Corporate reorganization; initial public offering. Y corporation is a closely held corporation. Y’s board of directors authorizes an initial public offering of Y’s stock to fund future growth. Y pays $5,000,000 in professional fees for investment banking services related to the determination of the offering price and legal services related to the development of the offering prospectus and the registration and issuance of stock. The investment banking and legal services are performed both before and after board authorization. Under paragraph (a)(8) of this section, the $5,000,000 is an amount paid to facilitate a stock issuance.

Example 16. Auction. (i) N corporation seeks to dispose of all of the stock of its wholly owned subsidiary, P corporation, through an auction process and requests that each bidder submit a non-binding purchase offer in the form of a draft agreement. Q corporation hires an investment banker to assist in the preparation of Q’s bid to acquire P and to conduct a due diligence investigation of P. On July 1, 2005, Q submits its draft agreement. On August 1, 2005, N informs Q that it has accepted Q’s offer, and presents Q with a signed letter of intent to sell all of the stock of P to Q. On August 5, 2005, Q’s board of directors approves the terms of the transaction and authorizes Q to execute the letter of intent. Q executes a binding letter of intent with N on August 6, 2005.

(ii) Under paragraph (e)(1) of this section, the amounts paid by Q to its investment banker that are not inherently facilitative and that are paid for activities performed prior to August 5, 2005 (the date Q’s board of directors approves the transaction) are not amounts paid to facilitate the acquisition of P. Amounts paid by Q to its investment banker for activities performed on or after August 5, 2005, and amounts paid by Q to its investment banker that are inherently facilitative amounts within the meaning of paragraph (e)(2) of this section are required to be capitalized under this section.

Example 17. Stock distribution. Z corporation distributes natural gas throughout state Y. The federal government brings an antitrust action against Z seeking divestiture of certain of Z’s natural gas distribution assets. As a result of a court ordered divestiture, Z and the federal government agree to a plan of divestiture that requires Z to organize a subsidiary to receive the divested assets and to distribute the stock of the subsidiary to its shareholders. During 2005, Z pays $300,000 to various independent contractors for the following services: studying customer demand in the area to be served by the divested assets, identifying assets to be transferred to the subsidiary, organizing the subsidiary, structuring the transfer of assets to the subsidiary to qualify as a tax-free transaction to capital, and distributing the stock of the subsidiary to the stockholders. Under paragraph (c)(3) of this section, Z is not required to capitalizes any portion of the $300,000 payments.

Example 18. Bankruptcy reorganization. (i) X corporation is the defendant in numerous lawsuits alleging tort liability based on X’s role in manufacturing certain defective products. X files a petition for reorganization under Chapter 11 of the Bankruptcy Code in an effort to manage all of the lawsuits in a single proceeding. X pays its outside counsel to prepare the petition and plan of reorganization, to analyze adequate protection under the plan, to attend hearings before the Bankruptcy Court concerning the plan, and to defend against motions by creditors and tort claimants to strike the taxpayer’s plan.

(ii) X’s reorganization under Chapter 11 of the Bankruptcy Code is a reorganization within the meaning of paragraph (a)(4) of this section. Under paragraph (c)(4) of this section, amounts paid by X to its outside counsel to prepare, analyze or obtain approval of the portion of X’s plan of reorganization that resolves X’s tort liability do not facilitate the reorganization and are not required to be capitalized, provided that such amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. All other amounts paid by X to its outside counsel for the services described above (including all amounts paid to prepare the bankruptcy petition) facilitate the reorganization and must be capitalized.

(m) Effective date. This section applies to amounts paid or incurred on or after December 31, 2003.

(n) Accounting method changes—(1) In general. A taxpayer seeking to change a method of accounting to comply with
this section must secure the consent of the Commissioner in accordance with the requirements of §1.446–1(e). For the taxpayer’s first taxable year ending on or after December 31, 2003, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with this section, provided the taxpayer follows the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner’s automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 C.B. 327) and §601.601(d)(2)(ii)(b) of this chapter).

(2) Scope limitations. Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003.

(3) Section 481(a) adjustment. The section 481(a) adjustment for a change in method of accounting to comply with this section for a taxpayer’s first taxable year ending on or after December 31, 2003 is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002.

[T.D. 9107, 69 FR 446, Jan. 5, 2004]

§ 1.263(b)–1 Expenditures for advertising or promotion of good will.

(6) Section 179B (deduction for capital costs incurred in complying with environmental protection agency sulfur regulations);

(7) Section 179C (election to expense certain refiners);

(8) Section 179D (energy efficient commercial buildings deduction);

(9) Section 179E (election to expense advanced mine safety equipment);

(10) Section 180 (expenditures by farmers for fertilizer);

(11) Section 181 (treatment of certain qualified film and television productions);

(12) Section 190 (expenditures to remove architectural and transportation barriers to the handicapped and elderly);

(13) Section 193 (tertiary injectants);

(14) Section 194 (treatment of reforestation expenditures);

(15) Section 195 (start-up expenditures);

(16) Section 198 (expensing of environmental remediation costs);

(17) Section 198A (expensing of qualified disaster expenses);

(18) Section 248 (organization expenditures of a corporation);

(19) Section 266 (carrying charges);

(20) Section 616 (development expenditures); and

(21) Section 709 (organization and syndication fees of a partnership).

(c) Effective/applicability date. This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see §1.263(a)–3 in effect prior to January 1, 2012 (§1.263(a)–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011). For the effective dates of the enumerated election provisions, see those Internal Revenue Code sections and the regulations thereunder.

(d) Expiration date. The applicability of this section expires on December 23, 2014.

provisions of section 733 or section 451 of the Internal Revenue Code of 1939, in computing its excess profits tax credit under Subchapter E, Chapter 2, or Subchapter D, Chapter 1, of the Internal Revenue Code of 1939.

§ 1.263(c)–1 Intangible drilling and development costs in the case of oil and gas wells.

For rules relating to the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells, see §1.612–4.

§ 1.263(e)–1 Expenditures in connection with certain railroad rolling stock.

(a) Allowance of deduction—(1) Election. Under section 263(e), for any taxable year beginning after December 31, 1969, a taxpayer may elect to treat certain expenditures paid or incurred during such taxable year as deductible repairs under section 162 or 212. This election applies only to expenditures described in paragraph (c) of this section in connection with the rehabilitation of a unit of railroad rolling stock (as defined in paragraph (b)(2) of this section) used by a domestic common carrier by railroad (as defined in paragraph (b)(3) and (4) of this section). However, an election under section 263(e) may not be made with respect to expenditures in connection with any unit of railroad rolling stock for which an election under section 263(f) and the regulations thereunder is in effect. An election made under section 263(e) is an annual election which may be made with respect to one or more of the units of railroad rolling stock owned by the taxpayer.

(2) Special 20 percent rule. Section 263(e) shall not apply if, under paragraph (d) of this section, expenditures paid or incurred during any period of 12 calendar months in connection with the rehabilitation of a unit exceed 20 percent of the basis (as defined in paragraph (b)(1) of this section) of such unit in the hands of the taxpayer. However, section 263(e) does not constitute a limit on the deduction of expenditures for repairs which are deductible without regard to such section. Accordingly, amounts otherwise deductible as repairs will continue to be deductible even though such amounts exceed 20 percent of the basis of the unit of railroad rolling stock in the hands of the taxpayer.

(3) Time and manner of making election. (i) An election by a taxpayer under section 263(e) shall be made by a statement to that effect attached to its income tax return or amended income tax return for the taxable year for which the election is made if such return or amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for the taxable year of election. An election under section 263(e) may be made with respect to one or more of the units of railroad rolling stock owned by the taxpayer. If an election is not made within the time and in the manner prescribed in this subparagraph, no election may be made (by the filing of an amended return or in any other manner) with respect to the taxable year.

(ii) If the taxpayer has filed a return on or before March 14, 1973, and has claimed a deduction under section 162 or 212 by reason of section 263(e), and if the taxpayer does not desire to make an election under section 263(e) for the taxable year with respect to which such return was filed, the taxpayer shall file an amended return for such taxable year on or before May 14, 1973, and shall pay any additional tax due for such year. The taxpayer shall also file an amended return for each taxable year which is affected by the filing of an amended return under the preceding sentence and shall pay any additional tax due for such year. Nothing in this subdivision shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(iii) If an election under section 263(e) was not made at the time the return for a taxable year was filed, and it is subsequently determined that an expenditure was erroneously treated as an expenditure which was not in connection with rehabilitation (as determined under paragraph (c) of this section), an election under section 263(e) may be made with respect to the unit of railroad rolling stock for which such expenditure was made for such taxable year, notwithstanding any provision in
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this subparagraph (3) to the contrary. Nothing in this subdivision shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(iv) The statement required by subdivision (i) of this subparagraph shall include the following information:

(a) The total number of units of railroad rolling stock with respect to which an election is being made under section 263(e).

(b) The aggregate basis (as defined in paragraph (b) (1) of this section) of the units described in (a) of this subdivision (iv), and

(c) The total deduction being claimed under section 263(e) for the taxable year.

(b) Definitions—(1) Basis. (i) In general, for purposes of section 263(e) the basis of a unit of railroad rolling stock shall be the adjusted basis of such unit determined without regard to the adjustments provided in paragraphs (1), (2), and (3) of section 1016(a) and section 1017. Thus, the basis of property would generally be its cost without regard to adjustments to basis such as for depreciation or for capital improvements. If the basis of a unit in the hands of a transferee is determined in whole or in part by reference to its basis in the hands of the transferor, for example, by reason of the application of section 362 (relating to basis to corporations), 374 (relating to gain or loss not recognized in certain railroad reorganizations), or 723 (relating to the basis of property contributed to a partnership), then the basis of such unit in the hands of the transferee for purposes of section 263(e) shall be its basis for purposes of section 263(e) in the hands of the transferor. Similarly, when the basis of a unit of railroad rolling stock in the hands of the taxpayer is determined in whole or in part by reference to the basis of another unit, for example, by reason of the application of the first sentence of section 1032(c) (relating to involuntary conversions), then the basis of the latter unit for purposes of section 263(e) shall be the basis for purposes of section 263(e) of the former unit. The question whether a capital expenditure in connection with a unit of railroad rolling stock results in the retirement of such unit and the creation of another unit of railroad rolling stock shall be determined without regard to rules under the uniform system of accounts prescribed by the Interstate Commerce Commission.

(ii) For example, if a unit of railroad rolling stock has a cost to M of $10,000 and because of depreciation adjustments of $4,000 and capital expenditures of $3,000, such unit has an adjusted basis in the hands of M of $9,000, the basis for purposes of section 263(e) of such unit in the hands of M is $10,000. Further, if M transfers such unit to N in a transaction in which no gain or loss is recognized such as, for example, a transaction to which section 351(a) (relating to a transfer to a corporation controlled by the transferor) applies, the basis of such unit for purposes of section 263(e) is $10,000 in the hands of N.

(2) Railroad rolling stock. For purposes of this section, the term unit or unit of railroad rolling stock means a unit of transportation equipment the expenditures for which are of a type chargeable (or in the case of property leased to a domestic common carrier by railroad, would be chargeable) to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission (49 CFR Part 1201), but only if (i) such unit exclusively moves on, moves under, or is guided by rail, and (ii) such unit is not a locomotive. Thus, for example, a unit of railroad rolling stock includes a box car, a gondola car, a passenger car, a car designed to carry truck trailers and containerized freight, a wreck crane, and a bunk car. However, such term does not include equipment which does not exclusively move on, move under, or is not exclusively guided by rail such as, for example, a barge, a tugboat, a container which is used on cars designed to carry containerized freight, a truck trailer, or an automobile. A locomotive is self-propelled equipment, the sole function of which is to push or pull railroad rolling stock. Thus, a self-propelled passenger or freight car is not a locomotive.

(3) Domestic common carrier by railroad. The term domestic common carrier by railroad means a railroad subject to
regulation under Part I of the Interstate Commerce Act (49 U.S.C. 1 et seq.) or a railroad which would be subject to regulation under Part I of the Interstate Commerce Act if it were engaged in interstate commerce.

(4) Use. For purposes of this section, a unit of railroad rolling stock is not used by a domestic common carrier by railroad if it is owned by a person other than a domestic common carrier by railroad and (i) is exclusively used for transportation by the owner or (ii) is exclusively used for transportation by another person which is not a domestic common carrier by railroad. Thus, for example, a unit of railroad rolling stock which is owned by a person which is not a domestic common carrier by railroad and is leased to a manufacturing company by the owner is not a unit of railroad rolling stock used by a domestic common carrier by railroad.

(c) Expenditures considered in connection with rehabilitation. For purposes of section 263(e) and this section all expenditures which would be properly chargeable to capital account but for the application of section 263(e) or (f) shall be considered to be expenditures in connection with the rehabilitation of a unit of railroad rolling stock. Expenditures which are paid or incurred in connection with incidental repairs or maintenance of a unit of railroad rolling stock and which are deductible without regard to section 263(e) or (f) shall not be included in any determination or computation under section 263(e) and shall not be treated as paid or incurred in connection with the rehabilitation of a unit of railroad rolling stock for purposes of section 263(e). The determination of whether an item would be, but for section 263(e) or (f), properly chargeable to capital account shall be made in a manner consistent with the principles for classification of expenditures as between capital and expenses under the Internal Revenue Code. See, for example, §§1.162-4, 1.263(a)-1, 1.263(a)-2, and paragraph (a)(4) (ii) and (iii) of §1.446-1. An expenditure shall be classified as capital or as expense without regard to its classification under the uniform system of accounts prescribed by the Interstate Commerce Commission.

(d) 20-percent limitation—(1) In general. No expenditures in connection with the rehabilitation of a unit of railroad rolling stock shall be treated as a deductible repair by reason of an election under section 263(e) if, during any period of 12 calendar months in which the expenditure is included falls, all such expenditures exceed an amount equal to 20 percent of the basis (as defined in paragraph (b)(1) of this section) of such unit in the hands of the taxpayer. All such expenditures shall be included in the computation of the 20-percent limitation even if such expenditures were deducted under section 263(f) in either the preceding or succeeding taxable year. Solely for purposes of the 20-percent limitation in this paragraph, such expenditures shall be deemed to be included in the month in which a rehabilitation of the unit of railroad rolling stock is completed. For the requirement that expenditures treated as repairs solely by reason of an election under section 263(e) be deducted in the taxable year paid or incurred, see paragraph (a) of this section.

(2) 12-month period. For purposes of this section, any period of 12 calendar months shall consist of any 12 consecutive calendar months except that calendar months prior to the calendar month of January 1970 shall not be included in determining such period.

(3) Period for certain corporate acquisitions. If a unit of railroad rolling stock to which section 263(e) applies is sold, exchanged, or otherwise disposed of in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor (see paragraph (b)(1) of this section), calendar months during which such unit is in the hands of the transferor and in the hands of such transferee shall both be included in the calendar months used by the transferor and the transferee to determine any period of 12 calendar months for purposes of section 263(e).

(4) Deduction allowed in year paid or incurred. If, based on the information available when the income tax return for a taxable year is filed, an expenditure paid or incurred in such taxable year would be deductible by reason of
the application of section 263(e) but for the fact that it cannot be established whether the 20-percent limitation in subparagraph (1) of this paragraph will be exceeded, the expenditure shall be deducted for such taxable year. If by reason of the application of such 20-percent limitation it is subsequently determined that such expenditure is not deductible as a repair, an amended return shall be filed for the year in which such deduction was treated as a deductible repair and additional tax, if any, for such year shall be paid. Appropriate adjustment with respect to the taxpayer’s tax liability for any other affected year shall be made. Nothing in this subparagraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(e) Recordkeeping requirements—(1) In general. Such records as will enable the accurate determination of the expenditures which may be subject to the treatment provided in section 263(e) shall be maintained. No deduction shall be allowed under section 162 or 212 by reason of section 263(e) with respect to a unit unless the taxpayer substantiates by adequate records that expenditures in connection with such unit of railroad rolling stock meet the requirements and limitations of this section.

(2) Separate records. A separate section 263(e) record shall be maintained for each unit with respect to which an election under section 263(e) is made. Such record shall:

(i) Identify the unit,

(ii) State the basis (as defined in paragraph (b)(1) of this section) and the date of acquisition of the unit,

(iii) Enumerate for each unit the amount of all expenditures incurred in connection with rehabilitation of such unit which would, but for section 263(e) or (f), be properly chargeable to capital account (including expenditures incurred by the taxpayer in connection with rehabilitation of such unit undertaken by a person other than the taxpayer) regardless of whether such expenditures during any 12-month period exceed 20 percent of the basis of such unit,

(iv) Describe the nature of the work in connection with each expenditure, and

(v) Specify the calendar month in which the rehabilitation is completed and the taxable year in which each expenditure is paid or incurred.

A section 263(e) record need only be prepared for a unit of railroad rolling stock for the period beginning on the first day of the eleventh calendar month immediately preceding the month in which the rehabilitation of such unit is completed and ending on the last day of the eleventh calendar month immediately succeeding such month. No section 263(e) record need be prepared for calendar months before January 1970.

(3) Records for certain expenditures: Expenditures determined to be incidental repairs and maintenance (referred to in paragraph (c) of this section) shall not be entered in the section 263(e) record. However, each taxpayer shall maintain records to reflect that such expenditures are properly deductible.

(4) Convenience rule. In general, expenditures and information maintained in compliance with subparagraphs (1) and (2) of this paragraph shall be recorded in the section 263(e) record of the specific unit with respect to which such expenditures are incurred. However, when a group of units of the same type are rehabilitated in a single project and the expenditure for each unit in the project will approximate the average expenditure per unit for the project, expenditures for the project may be aggregated without regard to the unit in the project with respect to which each expenditure is connected, and an amount equal to the aggregate expenditures for the project divided by the number of units in the project may be entered in the section 263(e) account of each unit in the project.

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

Example 1. M Corporation, a domestic common carrier by railroad, uses the calendar year as its taxable year. M owns and uses several gondola cars to which an election under section 263(e) applies for its taxable years 1970–1972. Gondola car No.1 has a basis (defined in paragraph (b)(1) of this section) of $10,000. No expenditures properly chargeable
to the section 263(e) record are made on gondola car No. 1 in 1970 and 1971, except in January 1971. In January 1971, M at a cost of $1,500 performed rehabilitation work on gondola car No. 1. Such amount was properly entered in the section 263(e) record for gondola car No. 1. Since the expenditures in such record do not exceed an amount equal to 20 percent of the basis of gondola car No. 1 ($2,000) during any period of 12 calendar months in which January 1971 falls, the expenditures during January 1971 shall be treated as a deductible expense regardless of what the treatment would have been if section 263(e) had not been enacted.

Example 2. Assume the same facts as in Example 1. Assume further that for 1970, 1971, and 1972, only the following expenditures in connection with rehabilitation which would, but for section 263(e), be properly chargeable to capital account were deemed included for gondola car No. 2:

(a) December 1970 ............................... $1,500
(b) November 1971 ............................... 600
(c) December 1971 ............................... 400
(d) January 1972 .................................... 1,050

Assume further that gondola car No. 2 has a basis (as defined in paragraph (b) (1) of this section) equal to $10,000, that M files its tax return by September 15 following each taxable year, and that each rehabilitation was completed in the month in which expenditures in connection with it were incurred. Any expenditures in connection with each gondola car (No. 1 or No. 2) have no effect on the treatment of expenditures in connection with the other gondola car. With respect to gondola car No. 2, the expenditures of December 1970 are treated as deductible repairs at the time M’s income tax return for 1970 is filed because, based on the information available when the income tax return for 1970 is filed, such expenditures would be deductible by reason of application of section 263(e) but for the fact that it cannot be established whether the 20-percent limitation in paragraph (d)(1) of this section will be exceeded. Nevertheless, because such expenditures during the period of 12 calendar months including calendar months December 1970 and November 1971 exceed $2,000, the December 1970 rehabilitation expenditures are not subject to the provisions of section 263(e). Because such rehabilitation expenditures during the period of 12 calendar months including calendar months February 1971 and January 1972 exceed $2,000, rehabilitation expenditures in 1971 are not subject to the provisions of section 263(e). Similarly, the 1972 rehabilitation expenditures are not subject to the provisions of section 263(e).

§ 1.263(f)–1 Reasonable repair allowance.

(a) For rules regarding the election of the repair allowance authorized by section 263(f), the definition of repair allowance property, and the conditions under which an election may be made, see paragraphs (d) (2) and (f) of §1.167(a)–11. An election may be made under this section for a taxable year only if the taxpayer makes an election under §1.167(a)–11 for such taxable year.

(Sec. 263(f), 85 Stat. 509 (26 U.S.C. 263))

[T.D. 7257, 38 FR 4255, Feb. 12, 1973]

§ 1.263A–0 Outline of regulations under section 263A.

This section lists the paragraphs in §§1.263A–1 through 1.263A–4 and §§1.263A–7 through 1.263A–15 as follows:

§ 1.263A–1 Uniform Capitalization of Costs.

(a) Introduction.
(1) In general.
(2) Effective dates.
(3) General scope.
(i) Property to which section 263A applies.
(ii) Property produced.
(iii) Property acquired for resale.
(iv) Inventories valued at market.
(v) Property produced in a farming business.
(vi) Creative property.
(vii) Property produced or property acquired for resale by foreign persons.
(b) Exceptions.
(1) Small resellers.
(2) Long-term contracts.
(3) Costs incurred in certain farming businesses.
(4) Costs incurred in raising, harvesting, or growing timber.
(5) Qualified creative expenses.
(6) Certain not-for-profit activities.
(7) Intangible drilling and development costs.
(8) Natural gas acquired for resale.
(i) Cushion gas.
(ii) Emergency gas.
(9) Research and experimental expenditures.
(10) Certain property that is substantially constructed.
(11) Certain property provided incident to services.
(i) In general.
(ii) Definition of services.
(iii) De minimis property provided incident to services.

[T.D. 7257, 38 FR 4255, Feb. 12, 1973]
(12) De minimis rule for certain producers with total indirect costs of $200,000 or less.

(13) Exception for the origination of loans.

(c) General operation of section 263A.

(1) Allocations.

(2) Otherwise deductible.

(3) Capitalize.

(4) Recovery of capitalized costs.

(d) Definitions.

(1) Self-constructed assets.

(2) Section 471 costs.

(i) In general.

(ii) New taxpayers.

(3) Additional section 263A costs.

(4) Section 263A costs.

(e) Types of costs subject to capitalization.

(1) In general.

(2) Direct costs.

(i) Producers.

(A) Direct material costs.

(B) Direct labor costs.

(ii) Resellers.

(B) Direct labor costs.

(3) Indirect costs.

(i) In general.

(ii) Examples of indirect costs required to be capitalized.

(A) Indirect labor costs.

(B) Officers’ compensation.

(C) Pension and other related costs.

(D) Employee benefit expenses.

(E) Indirect material costs.

(F) Purchasing costs.

(G) Handling costs.

(H) Storage costs.

(I) Cost recovery.

(J) Depletion.

(K) Rent.

(L) Taxes.

(M) Insurance.

(N) Utilities.

(O) Repairs and maintenance.

(P) Engineering and design costs.

(Q) Spoilage.

(R) Tools and equipment.

(S) Quality control.

(T) Bidding costs.

(U) Licensing and franchise costs.

(V) Interest.

(W) Capitalizable service costs.

(iii) Indirect costs not capitalized.

(A) Selling and distribution costs.

(B) Research and experimental expenditures.

(C) Section 179 costs.

(D) Section 165 losses.

(E) Cost recovery allowances on temporarily idle equipment and facilities.

(F) In general.

(2) Examples.

(F) Taxes assessed on the basis of income.

(G) Strike expenses.

(H) Warranty and product liability costs.

(I) On-site storage costs.

(J) Unsuccessful bidding expenses.

(K) Deductible service costs.

(i) Introduction.

(A) Definition of service costs.

(B) Definition of service departments.

(ii) Various service cost categories.

(A) Capitalizable service costs.

(B) Deductible service costs.

(C) Mixed service costs.

(iii) Examples of capitalizable service costs.

(F) Allocation of services.

(G) Accounting and reporting.

(i) In general.

(B) Development of burden rates.

(C) Operation of the burden rate method.

(ii) Standard cost method.

(A) In general.

(B) Treatment of variances.

(4) Reasonable allocation methods.

(g) Allocating categories of costs.

(1) Direct materials.

(2) Direct labor.

(3) Indirect costs.

(4) Service costs.

(i) In general.

(ii) De minimis rule.

(iii) Methods for allocating mixed service costs.

(A) Direct reallocation method.

(B) Step-allocation method.

(C) Examples.

(iv) Illustrations of mixed service cost allocations using reasonable factors or relationships.

(A) Security services.

(B) Legal services.

(C) Centralized payroll services.

(D) Centralized data processing services.

(E) Engineering and design services.

(F) Safety engineering services.

(G) Accounting method change.

(h) Simplified service cost method.

(1) Introduction.

(2) Eligible property.

(i) In general.

(A) Inventory property.

(B) Non-inventory property held for sale.

(C) Certain self-constructed assets.

(D) Self-constructed assets produced on a repetitive basis.

(ii) Election to exclude self-constructed assets.

(3) General allocation formula.

(4) Labor-based allocation ratio.

(5) Production cost allocation ratio.

(6) Definition of total mixed service costs.

(7) Costs allocable to more than one business.

(8) De minimis rule.

(9) Separate election.

(i) [Reserved]

(j) Special rules.

(1) Costs provided by a related person.

(i) In general.
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(i) Exceptions.
(2) Optional capitalization of period costs.
(i) In general.
(ii) Period costs eligible for capitalization.
(i) In general.
(ii) Trade or business application.
(i) In general.
(ii) Transfers with a principal purpose of tax avoidance. [Reserved]

§ 1.263A–2 Rules Relating to Property Produced by the Taxpayer.

(a) In general.
(1) Produce.
(i) In general.
(ii) Ownership.
(A) General rule.
(B) Property produced for the taxpayer under a contract.
(f) In general.
(2) Definition of contract.
(C) Home construction contracts.
(2) Tangible personal property.
(i) General rule.
(ii) Intellectual or creative property.
(A) Intellectual or creative property that is tangible personal property.
(1) Books.
(2) Sound recordings.
(B) Intellectual or creative property that is not tangible personal property.
(1) Evidences of value.
(2) Property provided incident to services.
(iii) Costs required to be capitalized by producers.
(1) In general.
(2) Pre-production costs.
(3) Post-production costs.
(4) Practical capacity concept.
(5) Taxpayers required to capitalize costs under this section.
(b) Simplified production method.
(1) Introduction.
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§ 1.263A–14 Rules for related persons.

§ 1.263A–15 Effective dates, transitional rules, and anti-abuse rule.
(a) Effective dates.
§ 1.263A–1 Uniform capitalization of costs.

(a) Introduction—(1) In general. The regulations under §§1.263A–1 through 1.263A–6 provide guidance to taxpayers that are required to capitalize certain costs under section 263A. These regulations generally apply to all costs required to be capitalized under section 263A except for interest that must be capitalized under section 263A(f) and the regulations thereunder. Statutory or regulatory exceptions may provide that section 263A does not apply to certain activities or costs; however, those activities or costs may nevertheless be subject to capitalization requirements under other provisions of the Internal Revenue Code and regulations.

(2) Effective dates. (i) In general, this section and §§ 1.263A–2 and 1.263A–3 apply to costs incurred in taxable years beginning after December 31, 1993. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning after December 31, 1993. Changes in methods of accounting necessary as a result of the rules in this section and §§1.263A–2 and 1.263A–3 must be made under terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of 1.263A–7 must be applied in revaluing inventory property.

(ii) For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A. For purposes of this paragraph (a)(2)(ii), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. See §601.601(d)(2)(ii)(b) of this chapter.

(3) General scope—(i) Property to which section 263A applies. Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to—

(A) Real property and tangible personal property produced by the taxpayer; and

(B) Real property and personal property described in section 1221(1), which is acquired by the taxpayer for resale.

(ii) Property produced. Taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property’s properly allocable share of indirect costs (described in paragraphs (e)(2)(i) and (3) of this section), regardless of whether the property is sold or used in the taxpayer’s trade or business. See §1.263A–2 for rules relating to producers.

(iii) Property acquired for resale. Retailers, wholesalers, and other taxpayers that acquire property described in section 1221(1) for resale (resellers) must capitalize the direct costs of acquiring the property and the property’s properly allocable share of indirect costs (described in paragraphs (e)(2)(ii) and (3) of this section). See §1.263A–3 for rules relating to resellers. See also section 263A(b)(2)(B), which excepts from section 263A personal property acquired for resale by a small reseller.

(iv) Inventories valued at market. Section 263A does not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property’s fair market value. For purposes of this paragraph (a)(3)(iv), the term fair market value means the price at which the taxpayer sells its inventory to its customers (e.g., as in the market value definition provided in §1.471–4(b)) less, if applicable, the direct cost of disposing of the inventory. However, section 263A does apply in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost. See §§1.471–4 and 1.471–5.

(v) Property produced in a farming business. Section 263A generally requires taxpayers engaged in a farming business to capitalize certain costs. See
sections 263A(d) and 263A(e) and §1.263A–4 for rules relating to taxpayers engaged in a farming business.

(vi) Creative property. Section 263A generally requires taxpayers engaged in the production and resale of creative property to capitalize certain costs.

(vii) Property produced or property acquired for resale by foreign persons. Section 263A generally applies to foreign persons.

(b) Exceptions—(1) Small resellers. See section 263A(b)(2)(B) for the §10,000,000 gross receipts exception for small resellers of personal property. See §1.263A–3(b) for rules relating to this exception. See also the exception for small resellers with de minimis production activities in §1.263A–3(a)(2)(i) and the exception for small resellers that have property produced under contract in §1.263A–3(a)(3).

(2) Long-term contracts. Except for certain home construction contracts described in section 460(e)(1), section 263A does not apply to any property produced by the taxpayer pursuant to a long-term contract as defined in section 460(f), regardless of whether the taxpayer uses an inventory method to account for such production.

(3) Costs incurred in certain farming businesses. See section 263A(d) for an exception for costs paid or incurred in certain farming businesses. See §1.263A–4 for specific rules relating to taxpayers engaged in the trade or business of farming.

(4) Costs incurred in raising, harvesting, or growing timber. See section 263A(c)(5) for an exception for costs paid or incurred in raising, harvesting, or growing timber and certain ornamental trees. See §1.263A–4, however, for rules relating to taxpayers producing certain trees to which section 263A applies.

(5) Qualified creative expenses. See section 263A(h) for an exception for qualified creative expenses paid or incurred by certain free-lance authors, photographers, and artists.

(6) Certain not-for-profit activities. See section 263A(c)(1) for an exception for property produced by a taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit. This exception does not apply, however, to property produced by an exempt organization in connection with its unrelated trade or business activities.

(7) Intangible drilling and development costs. See section 263A(c)(3) for an exception for intangible drilling and development costs. Additionally, section 263A does not apply to any amount allowable as a deduction under section 59(e) with respect to qualified expenditures under sections 263(c), 616(a), or 617(a).

(8) Natural gas acquired for resale. Under this paragraph (b)(8), section 263A does not apply to any costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs would otherwise be allocable to cushion gas.

(i) Cushion gas. Cushion gas is the portion of gas stored in an underground storage facility or reservoir that is required to maintain the level of pressure necessary for operation of the facility. However, section 263A applies to costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs are properly allocable to emergency gas.

(ii) Emergency gas. Emergency gas is natural gas stored in an underground storage facility or reservoir for use during periods of unusually heavy customer demand.

(9) Research and experimental expenditures. See section 263A(c)(2) for an exception for any research and experimental expenditure allowable as a deduction under section 174 or the regulations thereunder. Additionally, section 263A does not apply to any amount allowable as a deduction under section 59(e) with respect to qualified expenditures under section 174.

(10) Certain property that is substantially constructed. Section 263A does not apply to any property produced by a taxpayer for use in its trade or business if substantial construction occurred before March 1, 1986.

(i) For purposes of this section, substantial construction is deemed to have occurred if the lesser of—

(A) 10 percent of the total estimated costs of construction; or

(B) The greater of $10 million or 2 percent of the total estimated costs of construction, was incurred before March 1, 1986.
(ii) For purposes of the provision in paragraph (b)(10)(i) of this section, the total estimated costs of construction shall be determined by reference to a reasonable estimate, on or before March 1, 1986, of such amount. Assume, for example, that on March 1, 1986, the estimated costs of constructing a facility were $150 million. Assume that before March 1, 1986, $12 million of construction costs had been incurred. Based on the above facts, substantial construction would be deemed to have occurred before March 1, 1986, because $12 million (the costs of construction incurred before such date) is greater than $10 million (the lesser of $15 million; or the greater of $10 million or $3 million). For purposes of this provision, construction costs are defined as those costs incurred after construction commenced at the site of the property being constructed (unless the property will not be located on land and, therefore, the initial construction of the property must begin at a location other than the intended site). For example, in the case of a building, construction commences when work begins on the building, such as the excavation of the site, the pouring of pads for the building, or the driving of foundation pilings into the ground. Preliminary activities such as project engineering and architectural design do not constitute the commencement of construction, nor are such costs considered construction costs, for purposes of this paragraph (b)(10).

(11) Certain property provided incident to services—(i) In general. Under this paragraph (b)(11), section 263A does not apply to property that is provided to a client (or customer) incident to the provision of services by the taxpayer if the property provided to the client is—
(A) De minimis in amount; and
(B) Not inventory in the hands of the service provider.

(ii) Definition of services. For purposes of this paragraph (b)(11), services is defined with reference to its ordinary and accepted meaning under federal income tax principles. In determining whether a taxpayer is a bona-fide service provider under this paragraph (b)(11), the nature of the taxpayer’s trade or business and the facts and circumstances surrounding the taxpayer’s trade or business activities must be considered. Examples of taxpayers qualifying as service providers under this paragraph include taxpayers performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(iii) De minimis property provided incident to services. In determining whether property provided to a client by a service provider is de minimis in amount, all facts and circumstances, such as the nature of the taxpayer’s trade or business and the volume of its service activities in the trade or business, must be considered. A significant factor in making this determination is the relationship between the acquisition or direct materials costs of the property that is provided to clients and the price that the taxpayer charges its clients for its services and the property. For purposes of this paragraph (b)(11), if the acquisition or direct materials cost of the property provided to a client incident to the services is less than or equal to five percent of the price charged to the client for the services and property, the property is de minimis. If the acquisition or direct materials cost of the property exceeds five percent of the price charged for the services and property, the property may be de minimis if additional facts and circumstances so indicate.

(12) De minimis rule for certain producers with total indirect costs of $200,000 or less. See §1.263A–2(b)(3)(iv) for a de minimis rule that treats producers with total indirect costs of $200,000 or less as having no additional section 263A costs (as defined in paragraph (d)(3) of this section) for purposes of the simplified production method.

(13) Exception for the origination of loans. For purposes of section 263A(b)(2)(A), the origination of loans is not considered the acquisition of intangible property for resale. (But section 263A(b)(2)(A) does include the acquisition by a taxpayer of pre-existing loans from other persons for resale.)

(14) [Reserved] For further guidance, see §1.263A–1T(b)(14).

(c) General operation of section 263A—
(1) Allocations. Under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of
their indirect costs to property produced or property acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After section 263A costs are allocated to the appropriate production or resale activities, these costs are generally allocated to the items of property produced or property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. See however, the simplified production method and the simplified resale method in §§1.263A–2(b) and 1.263A–3(d).

(2) Otherwise deductible. (i) Any cost which (but for section 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale under section 263A and the regulations thereunder. Thus, for example, if a business meal deduction is limited by section 274(n) to 80 percent of the cost of the meal, the amount properly allocable to property produced or acquired for resale under section 263A is also limited to 80 percent of the cost of the meal.

(ii) The amount of any cost required to be capitalized under section 263A may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of §1.446–1(c)(1)(ii).

(3) Capitalize. Capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs and, in the case of other property, to charge to a capital account or basis.

(4) [Reserved] For further guidance, see §1.263A–1T(e)(4).

(d) Definitions—(1) Self-constructed assets. Self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to section 263A.

(2) Section 471 costs—(i) In general. Except as otherwise provided in paragraphs (d)(2)(ii) and (iii) of this section, for purposes of the regulations under section 263A, a taxpayer’s section 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of section 263A. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs, other than interest, capitalized or included in acquisition or production costs under the taxpayer’s method of accounting immediately prior to the effective date of section 263A.

(ii) New taxpayers. In the case of a new taxpayer, section 471 costs are those acquisition or production costs, other than interest, that would have been required to be capitalized by the taxpayer if the taxpayer had been in existence immediately prior to the effective date of section 263A.

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

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

(e) Types of costs subject to capitalization—(1) In general. Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale. This paragraph (e) describes the types of costs subject to section 263A.

(2) Direct costs—(i) Producers. Producers must capitalize direct material costs and direct labor costs.

(A) [Reserved] For further guidance, see §1.263A–1T(e)(2)(i)(A).

(B) Direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. For this purpose, labor encompasses full-time and part-time employees, as well as contract employees and independent contractors. Direct labor costs include all elements of compensation other than employee benefit costs described in paragraph (e)(3)(ii)(D) of this section. Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan.

(ii) Resellers. Resellers must capitalize direct labor costs and direct labor costs in the case of property currently being acquired or produced. In the case of inventory, the acquisition cost is the cost described in §1.471–3(b).

(3) Indirect costs—(i) In general. Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A. Taxpayers subject to section 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

(ii) Examples of indirect costs required to be capitalized. The following are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale:

(A) Indirect labor costs. Indirect labor costs include all labor costs (including the elements of labor costs set forth in paragraph (e)(2)(i) of this section) that cannot be directly identified or associated with particular units or groups of units of specific property produced or property acquired for resale (e.g., factory labor that is not direct labor). As in the case of direct labor, indirect labor encompasses full-time and part-time employees, as well as contract employees and independent contractors.

(B) Officers’ compensation. Officers’ compensation includes compensation paid to officers of the taxpayer.

(C) Pension and other related costs. Pension and other related costs include contributions paid to or made under any stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation, whether or not the plan qualifies under section 401(a). Contributions to employee plans representing past services must be capitalized in the same manner (and in the same proportion to property currently being acquired or produced) as amounts contributed for current service.

(D) Employee benefit expenses. Employee benefit expenses include all other employee benefit expenses (not described in paragraph (e)(3)(ii)(C) of this section) to the extent such expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code. These other employee benefit expenses include: worker’s compensation; amounts otherwise deductible or allowable in reducing
earnings and profits under section 404A; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation that has the effect of a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc. Employee benefit expenses do not, however, include direct labor costs described in paragraph (e)(2)(i) of this section.

(E) [Reserved] For further guidance, see §1.263A–1T(e)(3)(ii)(E).

(F) Purchasing costs. Purchasing costs include costs attributable to purchasing activities. See §1.263A–3(c)(3) for a further discussion of purchasing costs.

(G) Handling costs. Handling costs include costs attributable to processing, assembling, repackaging and transporting goods, and other similar activities. See §1.263A–3(c)(4) for a further discussion of handling costs.

(H) Storage costs. Storage costs include the costs of carrying, storing, or warehousing property. See §1.263A–3(c)(5) for a further discussion of storage costs.

(I) Cost recovery. Cost recovery includes depreciation, amortization, and cost recovery allowances on equipment and facilities (including depreciation or amortization of self-constructed assets or other previously produced or acquired property to which section 263A or section 263 applies).

(J) Depletion. Depletion includes allowances for depletion, whether or not in excess of cost. Depletion is, however, only properly allocable to property that has been sold (i.e., for purposes of determining gain or loss on the sale of the property).

(K) Rent. Rent includes the cost of renting or leasing equipment, facilities, or land.

(L) Taxes. Taxes include those taxes (other than taxes described in paragraph (e)(3)(iii)(F) of this section) that are otherwise allowable as a deduction to the extent such taxes are attributable to labor, materials, supplies, equipment, land, or facilities used in production or resale activities.

(M) Insurance. Insurance includes the cost of insurance on plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

(N) Utilities. Utilities include the cost of electricity, gas, and water.

(O) Repairs and maintenance. Repairs and maintenance include the cost of repairing and maintaining equipment or facilities.

(P) Engineering and design costs. Engineering and design costs include pre-production costs, such as costs attributable to research, experimental, engineering, and design activities (to the extent that such amounts are not research and experimental expenditures as described in section 174 and the regulations thereunder).

(Q) Spoilage. Spoilage includes the costs of rework labor, scrap, and spoilage.

(R) Tools and equipment. Tools and equipment include the costs of tools and equipment which are not otherwise capitalized.

(S) Quality control. Quality control includes the costs of quality control and inspection.

(T) Bidding costs. Bidding costs are costs incurred in the solicitation of contracts (including contracts pertaining to property acquired for resale) ultimately awarded to the taxpayer. The taxpayer must defer all bidding costs paid or incurred in the solicitation of a particular contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be rebid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs
first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of products, and the taxpayer was awarded a contract to build only one of the two types of products), the taxpayer shall deduct the portion of the bidding costs related to the portion of the bid not awarded to the taxpayer. In the case of a bid or proposal for a multi-unit contract, all bidding costs must be included in the costs allocated to the subject matter of the contract awarded to the taxpayer to produce or acquire for resale any of such units. For example, where the taxpayer submits one bid to produce three similar turbines and the taxpayer is awarded a contract to produce only two of the three turbines, all bidding costs must be included in the cost of the two turbines. For purposes of this paragraph (e)(3)(ii)(T), a contract means—

1. In the case of a specific unit of property, any agreement under which the taxpayer would produce or sell property to another party if the agreement is entered into before the taxpayer produces or acquires the specific unit of property to be delivered to the party under the agreement; and

2. In the case of fungible property, any agreement to the extent that, at the time the agreement is entered into, the taxpayer has on hand an insufficient quantity of completed fungible items of such property that may be used to satisfy the agreement (plus any other production or sales agreements of the taxpayer).

U. Licensing and franchise costs. Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (e.g., amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and royalties that are incurred by a licensee or a franchisee.

V. Interest. Interest includes interest on debt incurred or continued during the production period to finance the production of real property or tangible personal property to which section 263A(f) applies.

W. Capitalizable service costs. Service costs that are required to be capitalized include capitalizable service costs and capitalizable mixed service costs as defined in paragraph (e)(4) of this section.

(iii) Indirect costs not capitalized. The following indirect costs are not required to be capitalized under section 263A:

(A) Selling and distribution costs. These costs are marketing, selling, advertising, and distribution costs.

(B) Research and experimental expenditures. Research and experimental expenditures are expenditures described in section 174 and the regulations thereunder.

(C) Section 179 costs. Section 179 costs are expenses for certain depreciable assets deductible at the election of the taxpayer under section 179 and the regulations thereunder.

(D) Section 165 losses. Section 165 losses are losses under section 165 and the regulations thereunder.

(E) Cost recovery allowances on temporarily idle equipment and facilities—

(i) In general. Cost recovery allowances on temporarily idle equipment and facilities include only depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle. Equipment and facilities are temporarily idle when a taxpayer takes them out of service for a finite period. However, equipment and facilities are not considered temporarily idle—

(i) During worker breaks, non-working hours, or on regularly scheduled non-working days (such as holidays or weekends);

(ii) During normal interruptions in the operation of the equipment or facilities;

(iii) When equipment is enroute to or located at a job site; or

(iv) When under normal operating conditions, the equipment is used or operated only during certain shifts.
(2) Examples. The provisions of this paragraph (e)(3)(iii)(E) are illustrated by the following examples:

Example 1. Equipment operated only during certain shifts. Taxpayer A manufactures widgets. Although A’s manufacturing facility operates 24 hours each day in three shifts, A only operates its stamping machine during one shift each day. Because A only operates its stamping machine during certain shifts, A’s stamping machine is not considered temporarily idle during the two shifts that it is not operated.

Example 2. Facility shut down for retooling. Taxpayer B owns and operates a manufacturing facility. B closes its manufacturing facility for two weeks to retool its assembly line. B’s manufacturing facility is considered temporarily idle during this two-week period.

(F) Taxes assessed on the basis of income. Taxes assessed on the basis of income include only state, local, and foreign income taxes, and franchise taxes that are assessed on the taxpayer based on income.

(G) Strike expenses. Strike expenses include only costs associated with hiring employees to replace striking personnel (but not wages of replacement personnel), costs of security, and legal fees associated with settling strikes.

(H) Warranty and product liability costs. Warranty costs and product liability costs are costs incurred in fulfilling product warranty obligations for products that have been sold and costs incurred for product liability insurance.

(I) On-site storage costs. On-site storage costs are storage and warehousing costs incurred by a taxpayer at an on-site storage facility, as defined in §1.263A–3(c)(5)(ii)(A), with respect to property produced or property acquired for resale.

(J) Unsuccessful bidding expenses. Unsuccessful bidding costs are bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer.

(K) Deductible service costs. Service costs that are not required to be capitalized include deductible service costs and deductible mixed service costs as defined in paragraph (e)(4) of this section.

(4) Service costs—(1) Introduction. This paragraph (e)(4) provides definitions and categories of service costs. Paragraph (g)(4) of this section provides specific rules for determining the amount of service costs allocable to property produced or property acquired for resale. In addition, paragraph (h) of this section provides a simplified method for determining the amount of service costs that must be capitalized.

(A) Definition of service costs. Service costs are defined as a type of indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

(B) Definition of service departments. Service departments are defined as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer’s activities and business organization control whether a department is a service department. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

(ii) Various service cost categories—(A) Capitalizable service costs. Capitalizable service costs are defined as service costs that directly benefit or are incurred by reason of the performance of the production or resale activities of the taxpayer. Therefore, these service costs are required to be capitalized under section 263A. Examples of service departments or functions that incur capitalizable service costs are provided in paragraph (e)(4)(iii) of this section.

(B) Deductible service costs. Deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, are not required to be capitalized under section 263A. Deductible service costs generally include costs incurred by reason of the taxpayer’s overall management or policy guidance functions. In addition, deductible service costs include costs incurred by reason of the marketing, selling, advertising, and distribution activities of the taxpayer. Examples of service departments or functions that incur deductible service costs are provided in paragraph (e)(4)(iv) of this section.

(C) Mixed service costs. Mixed service costs are defined as service costs that...
are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, a personnel department may incur costs to recruit factory workers, the costs of which are allocable to production activities, and it may incur costs to develop wage, salary, and benefit policies, the costs of which are allocable to non-production activities.

(iii) Examples of capitalizable service costs. Costs incurred in the following departments or functions are generally allocated among production or resale activities:

(A) The administration and coordination of production or resale activities (wherever performed in the business organization of the taxpayer).

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees.

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery of materials and equipment to or from factories or job sites, and expediting and follow-up.

(D) Materials handling and warehousing and storage operations.

(E) Accounting and data services operations, including, for example, cost accounting, accounts payable, disbursements, and payroll functions (but excluding accounts receivable and customer billing functions).

(F) Data processing.

(G) Security services.

(H) Legal services.

(iv) Examples of deductible service costs. Costs incurred in the following departments or functions are not generally allocated to production or resale activities:

(A) Departments or functions responsible for overall management of the taxpayer or for setting overall policy for all of the taxpayer's activities or trades or businesses, such as the board of directors (including their immediate staff), and the chief executive, financial, accounting, and legal officers (including their immediate staff) of the taxpayer, provided that no substantial part of the cost of such departments or functions benefits a particular production or resale activity.

(B) Strategic business planning.

(C) General financial accounting.

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management).

(E) Personnel policy (such as establishing and managing personnel policy in general; developing wage, salary, and benefit policies; developing employee training programs unrelated to particular production or resale activities; negotiating with labor unions; and maintaining relations with retired workers).

(F) Quality control policy.

(G) Safety engineering policy.

(H) Insurance or risk management policy (but not including bid or performance bonds or insurance related to activities associated with property produced or property acquired for resale).

(I) Environmental management policy (except to the extent that the costs of any system or procedure benefits a particular production or resale activity).

(J) General economic analysis and forecasting.

(K) Internal audit.

(L) Shareholder, public, and industrial relations.

(M) Tax services.

(N) Marketing, selling, or advertising.

(f) Cost allocation methods—(1) Introduction. This paragraph (f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. Paragraph (g) of this section provides general rules for applying these allocation methods to various categories of costs (i.e., direct materials, direct labor, and indirect costs, including service costs). In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may use the simplified methods provided in §§1.263A-2(b) and 1.263A-3(d) to allocate direct and indirect costs to eligible property produced or eligible property acquired for resale; see those sections for definitions of eligible property. Paragraph (h) of this section provides a simplified
method for determining the amount of mixed service costs required to be capitalized to eligible property. The methodology set forth in paragraph (h) of this section for mixed service costs may be used in conjunction with either a facts-and-circumstances or a simplified method of allocating costs to eligible property produced or eligible property acquired for resale.

(2) *Specific identification method.* A specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective.

(3) *Burden rate and standard cost methods—(A) In general.* A burden rate method allocates an appropriate amount of indirect costs to property produced or property acquired for resale during a taxable year using predetermined rates that approximate the actual amount of indirect costs incurred by the taxpayer during the taxable year. Burden rates (such as ratios based on direct costs, hours, or similar items) may be developed by the taxpayer in accordance with acceptable accounting principles and applied in a reasonable manner. A taxpayer may allocate different indirect costs on the basis of different burden rates. Thus, for example, the taxpayer may use one burden rate for allocating the cost of rent and another burden rate for allocating the cost of utilities. Any periodic adjustment to a burden rate that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which such rates are developed, such as a change from basing the rates on direct labor hours to basing them on direct machine hours, is a change in method of accounting to which section 446(e) applies.

(B) *Development of burden rates.* The following factors, among others, may be used in developing burden rates:

(i) The selection of an appropriate level of activity and a period of time upon which to base the calculation of rates reflecting operating conditions for purposes of the unit costs being determined.

(ii) The selection of an appropriate statistical base, such as direct labor hours, direct labor dollars, machine hours, or a combination thereof, upon which to apply the overhead rate.

(iii) The appropriate budgeting, classification, and analysis of expenses (for example, the analysis of fixed versus variable costs).

(C) *Operation of the burden rate method.* The purpose of the burden rate method is to allocate an appropriate amount of indirect costs to production or resale activities through the use of predetermined rates intended to approximate the actual amount of indirect costs incurred. Accordingly, the proper use of the burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of costs allocated to property and the total amount of indirect costs actually incurred and required to be allocated to such property must be treated as an adjustment to the taxpayer's ending inventory or capital account (as the case may be) in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total indirect costs incurred with respect to production or resale activities for the year, such adjustment need not be allocated to the property produced or property acquired for resale unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

(ii) *Standard cost method—(A) In general.* A standard cost method allocates an appropriate amount of direct and indirect costs to property produced by the taxpayer through the use of preestablished standard allowances, without reference to costs actually incurred during the taxable year. A taxpayer may use a standard cost method to allocate costs, provided variances are treated in accordance with the procedures prescribed in paragraph (f)(3)(ii)(B) of this section. Any periodic adjustment to standard costs that
merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which standard costs are developed is a change in method of accounting to which section 446(e) applies.

(B) Treatment of variances. For purposes of this section, net positive overhead variance means the excess of total standard indirect costs over total actual indirect costs and net negative overhead variance means the excess of total actual indirect costs over total standard indirect costs. The proper use of a standard cost method requires that a taxpayer must reallocate to property a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct cost variances. The taxpayer must apportion such variances to or among the property to which the costs are allocable. However, if such variances are not significant in amount relative to the taxpayer’s total indirect costs incurred with respect to production and resale activities for the year, such variances need not be allocated to property produced or property acquired for resale unless such allocation is made in the taxpayer’s financial reports. A taxpayer must treat both positive and negative variances consistently.

(4) Reasonable allocation methods. A taxpayer may use the methods described in paragraph (f) (2) or (3) of this section if they are reasonable allocation methods within the meaning of this paragraph (f)(4). In addition, a taxpayer may use any other reasonable method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. An allocation method is reasonable if, with respect to the taxpayer’s production or resale activities taken as a whole—

(i) The total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in this section or in §§1.263A–2 and 1.263A–3, with appropriate consideration given to the volume and value of the taxpayer’s production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;

(ii) The allocation method is applied consistently by the taxpayer; and

(iii) The allocation method is not used to circumvent the requirements of the simplified methods in this section or in §1.263A–2, §1.263A–3, or the principles of section 263A.

(g) Allocating categories of costs—

(1) Direct materials. Direct material costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year must be allocated to the property produced or property acquired for resale by the taxpayer using the taxpayer’s method of accounting for materials (e.g., specific identification; first-in, first-out (FIFO); or last-in, first-out (LIFO)), or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(2) Direct labor. Direct labor costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year are generally allocated to property produced or property acquired for resale using a specific identification method, standard cost method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section). All elements of compensation, other than basic compensation, may be grouped together and then allocated in proportion to the charge for basic compensation. Further, a taxpayer is not treated as using an erroneous method of accounting if direct labor costs are treated as indirect costs under the taxpayer’s allocation method, provided such costs are capitalized to the extent required by paragraph (g)(3) of this section.

(3) Indirect costs. Indirect costs (as defined in paragraph (e)(3) of this section) are generally allocated to intermediate cost objectives such as departments or activities prior to the allocation of such costs to property produced or property acquired for resale. Indirect costs are allocated using either a specific identification method, a standard cost method, a burden rate method, or...
any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(4) Service costs—(i) In general. Service costs are a type of indirect costs that may be allocated using the same allocation methods available for allocating other indirect costs described in paragraph (g)(3) of this section. Generally, taxpayers that use a specific identification method or another reasonable allocation method must allocate service costs to particular departments or activities based on a factor or relationship that reasonably relates the service costs to the benefits received from the service departments or activities. For example, a reasonable factor for allocating legal services to particular departments or activities is the number of hours of legal services attributable to each department or activity. See paragraph (g)(4)(iv) of this section for other illustrations. Using reasonable factors or relationships, a taxpayer must allocate mixed service costs under a direct reallocation method described in paragraph (g)(4)(iii)(A) of this section, a step-allocation method described in paragraph (g)(4)(iii)(B) of this section, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(ii) De minimis rule. For purposes of administrative convenience, if 90 percent or more of a mixed service department’s costs are deductible service costs, a taxpayer may elect not to allocate any portion of the service department’s costs to property produced or property acquired for resale. For example, if 90 percent of the costs of an electing taxpayer’s industrial relations department benefit the taxpayer’s overall policy-making activities, the taxpayer is not required to allocate any portion of these costs to a production activity. Under this election, however, if 90 percent or more of a mixed service department’s costs are capitalizable service costs, a taxpayer must allocate 100 percent of the department’s costs to the production or resale activity benefitted. For example, if 90 percent of the costs of an electing taxpayer’s accounting department benefitted the taxpayer’s manufacturing activity, the taxpayer must allocate 100 percent of the costs of the accounting department to the manufacturing activity. An election under this paragraph (g)(4)(ii) applies to all of a taxpayer’s mixed service departments and constitutes the adoption of a (or a change in) method of accounting under section 446 of the Internal Revenue Code.

(iii) Methods for allocating mixed service costs—(A) Direct reallocation method. Under the direct reallocation method, the total costs (direct and indirect) of all mixed service departments are allocated only to departments or cost centers engaged in production or resale activities and then from those departments to particular activities. This direct reallocation method ignores benefits provided by one mixed service department to other mixed service departments, and also excludes other mixed service departments from the base used to make the allocation.

(B) Step-allocation method. (1) Under a step-allocation method, a sequence of allocations is made by the taxpayer. First, the total costs of the mixed service departments that benefit the greatest number of other departments are allocated to—

(i) Other mixed service departments;

(ii) Departments that incur only deductible service costs; and

(iii) Departments that exclusively engage in production or resale activities.

(2) A taxpayer continues allocating mixed service costs in the manner described in paragraph (g)(4)(ii)(B)(1) of this section (i.e., from the service departments benefitting the greatest number of departments to the service departments benefitting the least number of departments) until all mixed service costs are allocated to the types of departments listed in this paragraph (g)(4)(iii). Thus, a step-allocation method recognizes the benefits provided by one mixed service department to another mixed service department and also includes mixed service departments that have not yet been allocated in the base used to make the allocation.

(C) Examples. The provisions of this paragraph (g)(4)(iii) are illustrated by the following examples:
Example 1. Direct reallocation method. (i) Taxpayer E has the following five departments: the Assembling Department, the Painting Department, and the Finishing Department (production departments), and the Personnel Department and the Data Processing Department (mixed service departments). E allocates the Personnel Department’s costs on the basis of total payroll costs and the Data Processing Department’s costs on the basis of data processing hours. (ii) Under a direct reallocation method, E allocates the Personnel Department’s costs directly to its Assembling, Painting, and Finishing Department, and not to its Data Processing department.

<table>
<thead>
<tr>
<th>Department</th>
<th>Total dept. costs</th>
<th>Amount of payroll costs</th>
<th>Allocation ratio</th>
<th>Amount allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel</td>
<td>$500,000</td>
<td>$50,000</td>
<td></td>
<td>&lt;$500,000&gt;</td>
</tr>
<tr>
<td>Data Proc’g</td>
<td>250,000</td>
<td>15,000</td>
<td></td>
<td>25,000</td>
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<tr>
<td>Assembling</td>
<td>250,000</td>
<td>15,000</td>
<td>15,000/285,000</td>
<td>26,315</td>
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<tr>
<td>Painting</td>
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<td>90,000</td>
<td>90,000/285,000</td>
<td>167,895</td>
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<tr>
<td>Finishing</td>
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<td>180,000</td>
<td>180,000/285,000</td>
<td>315,790</td>
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<tr>
<td>Total</td>
<td>$4,000,000</td>
<td>$350,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(iii) After E allocates the Personnel Department’s costs, E then allocates the costs of its Data Processing Department in the same manner.

<table>
<thead>
<tr>
<th>Department</th>
<th>Total dept. cost after initial allocation</th>
<th>Total data proc. hours</th>
<th>Allocation ratio</th>
<th>Amount allocated</th>
<th>Total dept. cost after final allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel</td>
<td>0</td>
<td>2,000</td>
<td></td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Data Proc’g</td>
<td>$250,000</td>
<td></td>
<td></td>
<td>$250,000</td>
<td>$326,315</td>
</tr>
<tr>
<td>Assembling</td>
<td>276,315</td>
<td>2,000</td>
<td>2,000/10,000</td>
<td>50,000</td>
<td>2,315,790</td>
</tr>
<tr>
<td>Painting</td>
<td>1,157,895</td>
<td>0</td>
<td>0/10,000</td>
<td>0</td>
<td>1,157,895</td>
</tr>
<tr>
<td>Finishing</td>
<td>2,315,790</td>
<td>8,000</td>
<td>8,000/10,000</td>
<td>200,000</td>
<td>2,515,790</td>
</tr>
<tr>
<td>Total</td>
<td>$4,000,000</td>
<td>12,000</td>
<td></td>
<td>$4,000,000</td>
<td></td>
</tr>
</tbody>
</table>

Example 2. Step-allocation method. (i) Taxpayer F has the following five departments: the Manufacturing Department (a production department), the Marketing Department and the Finance Department (departments that incur only deductible service costs), the Personnel Department and the Data Processing Department (mixed service departments). F uses a step-allocation method and allocates the Personnel Department’s costs on the basis of total payroll costs and the Data Processing Department’s costs on the basis of data processing hours. F’s Personnel Department benefits all four of F’s other departments, while its Data Processing Department benefits only three departments. Because F’s Personnel Department benefits the greatest number of other departments, F first allocates its Personnel Department’s costs to its Manufacturing, Marketing, Finance and Data Processing departments, as follows:

<table>
<thead>
<tr>
<th>Department</th>
<th>Total cost of dept.</th>
<th>Total payroll costs</th>
<th>Allocation ratio</th>
<th>Amount allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel</td>
<td>$500,000</td>
<td>$50,000</td>
<td></td>
<td>&lt;$500,000&gt;</td>
</tr>
<tr>
<td>Data Proc’g</td>
<td>250,000</td>
<td>15,000</td>
<td>15,000/300,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Finance</td>
<td>250,000</td>
<td>15,000</td>
<td>15,000/300,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Marketing</td>
<td>1,000,000</td>
<td>90,000</td>
<td>90,000/300,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Manufac’g</td>
<td>2,000,000</td>
<td>180,000</td>
<td>180,000/300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Total</td>
<td>4,000,000</td>
<td>350,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(ii) Under a step-allocation method, the denominator of F’s allocation ratio includes the payroll costs of its Manufacturing, Marketing, Finance, and Data Processing departments.

(iii) Next, F allocates the costs of its Data Processing Department on the basis of data processing hours. Because the costs incurred by F’s Personnel Department have already been allocated, no allocation is made to the Personnel Department.
(iv) Under the second step of F’s step-allocation method, the denominator of F’s allocation ratio includes the data processing hours of its Manufacturing, Marketing, and Finance Departments, but does not include the data processing hours of its Personnel Department (the other mixed service department) because the costs of that department have previously been allocated.

(iv) Illustrations of mixed service cost allocations using reasonable factors or relationships. This paragraph (g)(4)(iv) illustrates various reasonable factors and relationships that may be used in allocating different types of mixed service costs. Taxpayers, however, are permitted to use other reasonable factors and relationships to allocate mixed service costs. In addition, the factors or relationships illustrated in this paragraph (g)(4)(iv) may be used to allocate other types of service costs not illustrated in this paragraph (g)(4)(iv).

(A) Security services. The costs of security or protection services must be allocated to each physical area that receives the services using any reasonable method applied consistently (e.g., the size of the physical area, the number of employees in the area, or the relative fair market value of assets located in the area).

(B) Legal services. The costs of legal services are generally allocable to a particular production or resale activity on the basis of the approximate number of hours of legal service performed in connection with the activity, including research, bidding, negotiating, drafting, reviewing a contract, obtaining necessary licenses and permits, and resolving disputes. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any activity, estimates are appropriate, detailed time records are not required to be kept, and insubstantial amounts of services provided to an activity by senior legal staff (such as administrators or reviewers) may be ignored. Legal costs may also be allocated to a particular production or resale activity based on the ratio of the total direct costs incurred for the activity to the total direct costs incurred with respect to all production or resale activities. The taxpayer must also allocate directly to an activity the cost incurred for any outside legal services. Legal costs relating to general corporate functions are not required to be allocated to a particular production or resale activity.

(C) Centralized payroll services. The costs of a centralized payroll department or activity are generally allocated to the departments or activities benefitted on the basis of the gross dollar amount of payroll processed.

(D) Centralized data processing services. The costs of a centralized data processing department are generally allocated to all departments or activities benefitted using any reasonable basis, such as total direct data processing costs or the number of data processing hours supplied. The costs of data processing systems or applications developed for a particular activity are directly allocated to that activity.

(E) Engineering and design services. The costs of an engineering or a design department are generally directly allocable to the departments or activities benefitted based on the ratio of the approximate number of hours of work performed with respect to the particular activity to the total number of hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates.
(F) Safety engineering services. The costs of a safety engineering departments or activities generally benefit all of the taxpayer's activities and, thus, should be allocated using a reasonable basis, such as: the approximate number of safety inspections made in connection with a particular activity as a fraction of total inspections, the number of employees assigned to an activity as a fraction of total employees, or the total labor hours worked in connection with an activity as a fraction of total hours. However, in determining the allocable costs of a safety engineering department, costs attributable to providing a safety program relating only to a particular activity must be directly assigned to such activity. Additionally, the cost of a safety engineering department only responsible for setting safety policy and establishing safety procedures to be used in all of the taxpayer's activities is not required to be allocated.

(v) Accounting method change. A change in the method or base used to allocate service costs (such as changing from an allocation base using direct labor costs to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are to be allocated, is a change in method of accounting to which section 446(e) and the regulations thereunder apply.

(h) Simplified service cost method—(1) Introduction. This paragraph (h) provides a simplified method for determining capitalizable mixed service costs incurred during the taxable year with respect to eligible property (i.e., the aggregate portion of mixed service costs that are properly allocable to the taxpayer's production or resale activities).

(2) Eligible property—(1) In general. Except as otherwise provided in paragraph (h)(2)(i) of this section, the simplified service cost method, if elected for any trade or business of the taxpayer, must be used for all production and resale activities of the trade or business associated with any of the following categories of property that are subject to section 263A:

(A) Inventory property. Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) Non-inventory property held for sale. Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) Certain self-constructed assets. Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) Self-constructed tangible personal property produced on a routine and repetitive basis—(1) In general. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business when units of tangible personal property (as defined in §1.263A–10(c)) are mass-produced, that is, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and either the applicable recovery period of the property determined under section 168(c) is not longer than 3 years or the property is a material or supply that will be used and consumed within 3 years of being produced. For purposes of this paragraph (h)(2)(i)(D), the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of §1.46–3(d). Subsequent changes to the applicable recovery period after the assets are placed in service will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph (h)(2)(i)(D).

(2) Examples. The following examples illustrate this paragraph (h)(2)(i)(D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces numerous substantially identical dies and
molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c). Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y’s business for purposes of this paragraph because the dies and molds are both mass-produced and have a recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(c). The poles are not produced on a routine and repetitive basis in the ordinary course of Z’s business for purposes of this paragraph because the poles have an applicable recovery period that is longer than 3 years.

(ii) Election to exclude self-constructed assets. At the taxpayer’s election, the simplified service cost method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (h)(2)(1)(A) and (B) of this section. Taxpayers electing to exclude the self-constructed assets described in paragraphs (h)(2)(1)(C) and (D) of this section from application of the simplified service cost method must, however, allocate service costs to such property in accordance with paragraph (g)(4) of this section.

(3) General allocation formula. (i) Under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs using the following formula:

\[
\text{Allocation ratio} \times \text{total mixed service costs}
\]

(ii) A producer may elect one of two allocation ratios, the labor-based allocation ratio or the production cost allocation ratio. A reseller that satisfies the requirements for using the simplified resale method of §1.263A–3(d) (whether or not that method is elected) may elect the simplified service cost method, but must use a labor-based allocation ratio. (See §1.263A–3(d) for labor-based allocation ratios to be used in conjunction with the simplified resale method.) The allocation ratio used by a trade or business of a taxpayer is a method of accounting which must be applied consistently within the trade or business.

(4) Labor-based allocation ratio. (i) The labor-based allocation ratio is computed as follows:

Section 263A labor costs

<table>
<thead>
<tr>
<th>Total labor costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>(ii) Section 263A labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) allocable to property produced and property acquired for resale under section 263A that are incurred in the taxpayer’s trade or business during the taxable year. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) incurred in the taxpayer’s trade or business during the taxable year.</td>
</tr>
</tbody>
</table>

(5) Production cost allocation ratio. (i) Producers may use the production cost allocation ratio, computed as follows:

Section 263A production costs

<table>
<thead>
<tr>
<th>Total costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>(ii) Section 263A production costs are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities)</td>
</tr>
</tbody>
</table>

VerDate Mar<15>2010 11:25 May 22, 2012 Jkt 226088 PO 00000 Frm 00658 Fmt 8010 Sfmt 8010 Y:\SGML\226088.XXX 226088
under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total costs are defined as all costs (excluding mixed service costs and interest) incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) as well as all other costs of the taxpayer's trade or business, including, but not limited to: salaries and other labor costs of all personnel; all depreciation taken for federal income tax purposes; research and experimental expenditures; and selling, marketing, and distribution costs. Such costs do not include, however, taxes described in paragraph (e)(3)(iii)(F) of this section. For example, taxpayer H, a producer, incurs $1,000 of total mixed service costs in the taxable year. H's section 263A production costs are $10,000 and its total costs are $20,000. Under the production cost allocation ratio, H's capitalizable mixed service costs are $500 (i.e., $1,000 X ($10,000 divided by $20,000)).

(6) Definition of total mixed service costs. Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. See paragraph (e)(3)(iii)(F) of this section which defines mixed service costs. In determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. For example, if the accounting department within a trade or business is a mixed service department, then in determining the total mixed service costs of the trade or business, the taxpayer cannot exclude the costs of personnel in the accounting department that perform services relating to non-production activities (e.g., accounts receivable or customer billing activities). Instead, the entire cost of the accounting department must be included in the total mixed service costs.

(7) Costs allocable to more than one business. To the extent mixed service costs, labor costs, or other costs are incurred in more than one trade or business, the taxpayer must determine the amounts allocable to the particular trade or business for which the simplified service cost method is being applied by using any reasonable allocation method consistent with the principles of paragraph (f)(4) of this section.

(8) De minimis rule. If the taxpayer elects to apply the de minimis rule of paragraph (g)(4)(ii) of this section to any mixed service department, the department is not considered a mixed service department for purposes of the simplified service cost method. Instead, the costs of such department are allocated exclusively to the particular activity satisfying the 90-percent test.

(9) Separate election. A taxpayer may elect the simplified service cost method in conjunction with any other allocation method used at the trade or business level, including the simplified methods described in §§ 1.263A–2(b) and 1.263A–3(d). However, the election of the simplified service cost method must be made independently of the election to use those other simplified methods.

(i) [Reserved]

(j) Special rules—(1) Costs provided by a related person—(i) In general. A taxpayer subject to section 263A must capitalize an arm's-length charge for any section 263A costs (e.g., costs of materials, labor, or services) incurred by a related person that are properly allocable to the property produced or property acquired for resale by the taxpayer. Both the taxpayer and the related person must account for the transaction as if an arm's-length charge had been incurred by the taxpayer with respect to its property produced or property acquired for resale. For purposes of this paragraph (j)(1)(i), a taxpayer is considered related to another person if the taxpayer and such person are described in section 482. Further, for purposes of this paragraph (j)(1)(i), arm's-length charge means the arm's-length charge (or other appropriate charge where permitted and applicable) under the principles of section 482. Any correlative adjustments necessary because of the arm's-length charge requirement of this paragraph
(j)(1)(i) shall be determined under the principles of section 482.  

(ii) Exceptions. The provisions of paragraph (j)(1)(i) of this section do not apply if, and to the extent that—

(A) It would be inappropriate under the principles of section 482 for the Commissioner to adjust the income of the taxpayer or the related person with respect to the transaction at issue; or

(B) A transaction is accounted for under an alternative Internal Revenue Code section resulting in the capitalization (or deferral of the deduction) of the costs of the items provided by the related party and the related party does not deduct such costs earlier than the costs would have been deducted by the taxpayer if the costs were capitalized under section 263A. See § 1.1502–13.

(2) Optional capitalization of period costs—(i) In general. Taxpayers are not required to capitalize indirect costs that do not directly benefit or are not incurred by reason of the production of property or acquisition of property for resale (i.e., period costs). A taxpayer may, however, elect to capitalize certain period costs if: The method is consistently applied; is used in computing beginning inventories, ending inventories, and cost of goods sold; and does not result in a material distortion of the taxpayer’s income. A material distortion relates to the source, character, amount, or timing of the cost capitalized or any other item affected by the capitalization of the cost. Thus, for example, a taxpayer may not capitalize a period cost under section 263A if capitalization would result in a material change in the computation of the foreign tax credit limitation under section 904. An election to capitalize a period cost is the adoption of (or a change in) a method of accounting under section 263A. See § 1.1502–13.

(ii) Period costs eligible for capitalization. The types of period costs eligible for capitalization under this paragraph (j)(2) include only the types of period costs (e.g., under paragraph (e)(3)(ii)) of this section for which some portion of the costs incurred is properly allocable to property produced or property acquired for resale in the year of the election. Thus, for example, marketing or advertising costs, no portion of which are properly allocable to property produced or property acquired for resale, do not qualify for elective capitalization under this paragraph (j)(2).

(3) Trade or business application. Notwithstanding the references generally to taxpayer throughout this section and §§ 1.263A–2 and 1.263A–3, the methods of accounting provided under section 263A are to be elected and applied independently for each separate and distinct trade or business of the taxpayer in accordance with the provisions of section 446(d) and the regulations thereunder.

(4) Transfers with a principal purpose of tax avoidance. The District Director may require appropriate adjustments to valuations of inventory and other property subject to section 263A if a transfer of property is made to another person for a principal purpose of avoiding the application of section 263A. Thus, for example, the District Director may require a taxpayer using the simplified production method of § 1.263A–2(b) to apply that method to transferred inventories immediately prior to a transfer under section 351 if a principal purpose of the transfer is to avoid the application of section 263A.

(k) Change in method of accounting—(1) In general. A change in a taxpayer’s treatment of mixed service costs to comply with paragraph (h)(2)(i)(D) of this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations under those sections apply. See § 1.263A–7. For a taxpayer’s first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (k)(2) through (4) of this section, issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner’s automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 CB 327), as modified and clarified by Announcement 2002–17 (2002–1 CB 561), modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), and amplified, clarified, and modified by Rev. Proc. 2002–54 (2002–2 CB 432), and
§ 1.263A–1T Uniform capitalization of costs (temporary).

(a) through (b)(13) [Reserved] For further guidance, see §1.263A–1T(b)(13).

(14) Property subject to de minimis rule. Section 263A does not apply to the costs of property produced by a taxpayer to which the taxpayer properly applies the de minimis rule under §1.263(a)–2T(g). However, the cost of property to which a taxpayer properly applies the de minimis rule under §1.263(a)–2T(g) may be required to be capitalized to other property as a cost incurred by reason of the production of the other property that is subject to section 263A.

(c)(1) through (c)(3) [Reserved] For further guidance, see §1.263A–1T(c)(1) through (c)(3).

(4) Recovery of capitalized costs. Except as provided in §1.162–2T(a)(2) (amounts paid to produce incidental materials and supplies), costs that are
capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to use, sale, or disposition of property.

(d)(1) through (e)(2)(i) [Reserved] For further guidance, see §1.263A–1(d)(1) through (e)(2)(i).

(A) Direct material costs. Direct materials costs include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. For example, a cost described in §1.162–3T, relating to the cost of a material or supply, may be a direct material cost.

(e)(2)(ii)(F) through (k)(5) [Reserved] For further guidance, see §1.263A–1(e)(2)(ii)(F) through (k)(5).

(E) Indirect material costs. Indirect material costs include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units of property. Thus, for example, a cost described in §1.162–3T, relating to the cost of a material or supply, may be an indirect cost.

(m) Effective/applicability date. (1) Paragraphs (b)(2)(i)(D), (k), and (m)(1) of this section apply for taxable years ending on or after August 2, 2005.

(2) Paragraph (b)(14), the introductory phrase of paragraph (c)(4), the last sentence of paragraphs (e)(2)(i)(A) and (e)(2)(ii)(E), paragraph (l), and paragraph (m)(2) of this section apply to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012. For the applicability of §1.263A–1 to taxable years beginning before January 1, 2012, see §1.263A–1 in effect prior to January 1, 2012 (§1.263A–1 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(3) Expiration date. The applicability of this section expires on December 23, 2014.

[T.D. 9564, 76 FR 81126, Dec. 27, 2011]

§ 1.263A–2 Rules relating to property produced by the taxpayer.

(a) In general. Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers. In addition, section 263A applies to property produced for a taxpayer under a contract with another party. The principal terms related to the scope of section 263A with respect to producers are provided in this paragraph (a). See §1.263A–1(b)(11) for an exception in the case of certain de minimis property provided to customers incident to the provision of services.

(1) Produce—(i) In general. For purposes of section 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

(ii) Change in method of accounting for de minimis costs. A change in the treatment of amounts paid for property subject to the de minimis rule to comply with paragraph (b)(14) of this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to a method of accounting permitted in paragraph (b)(14) of this section must secure the consent of the Commissioner in accordance with §1.446–1(e) and follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(2) Ownership—(A) General rule. Except as provided in paragraphs (a)(1)(i) (B) and (C) of this section, a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. The determination as to whether a taxpayer is an owner is based on all of the facts and circumstances, including the
various benefits and burdens of ownership vested with the taxpayer. A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property.

(B) Property produced for the taxpayer under a contract—(1) In general. Property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. A taxpayer has made payment under this section if the transaction would be considered payment by a taxpayer using the cash receipts and disbursements method of accounting.

(2) Definition of a contract—(i) General rule. Except as provided under paragraph (a)(1)(ii)(B)(2)(ii) of this section, a contract is any agreement providing for the production of property if the agreement is entered into before the production of the property to be delivered under the contract is completed. Whether an agreement exists depends on all the facts and circumstances. Facts and circumstances indicating an agreement include, for example, the making of a prepayment, or an arrangement to make a prepayment, for property prior to the date of the completion of production of the property, or the incurring of significant expenditures for property of specialized design or specialized application that is not intended for self-use.

(ii) Routine purchase order exception. A routine purchase order for fungible property is not treated as a contract for purposes of this section. An agreement will not be treated as a routine purchase order for fungible property, however, if the contractor is required to make more than de minimis modifications to the property to tailor it to the customer’s specific needs, or if at the time the agreement is entered into, the customer knows or has reason to know that the contractor cannot satisfy the agreement within 30 days out of existing stocks and normal production of finished goods.

(A) Intellectual or creative property that is tangible personal property. Section 263A applies to tangible personal property defined in this paragraph (a)(2) without regard to whether such property is treated as tangible or intangible property under other sections of the Internal Revenue Code. Thus, for example, section 263A applies to the costs of producing a motion picture or research and writing a book even though these assets may be considered
intangible for other purposes of the Internal Revenue Code. Tangible personal property includes, for example, the following:

(1) Books. The costs of producing and developing books (including teaching aids and other literary works) required to be capitalized under this section include costs incurred by an author in researching, preparing, and writing the book. (However, see section 263A(h), which provides an exemption from the capitalization requirements of section 263A in the case of certain free-lance authors.) In addition, the costs of producing and developing books include prepublication expenditures incurred by publishers, including payments made to authors (other than commissions for sales of books that have already taken place), as well as costs incurred by publishers in writing, editing, compiling, illustrating, designing, and developing the books. The costs of producing a book also include the costs of producing the underlying manuscript, copyright, or license. (These costs are distinguished from the separately capitalizable costs of printing and binding the tangible medium embodying the book (e.g., paper and ink).) See §1.174–2(a)(1), which provides that the term research or experimental expenditures does not include expenditures for research in connection with literary, historical, or similar projects.

(2) Sound recordings. A sound recording is a work that results from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material objects, such as discs, tapes, or other phonorecordings, in which such sounds are embodied.

(B) Intellectual or creative property that is not tangible personal property. Items that are not considered tangible personal property within the meaning of section 263A(b) and paragraph (a)(2)(ii) of this section include:

(1) Evidences of value. Tangible personal property does not include property that is representative or evidence of value, such as stock, securities, debt instruments, mortgages, or loans.

(2) Property provided incident to services. Tangible personal property does not include de minimis property provided to a client or customer incident to the provision of services, such as wills prepared by attorneys, or blueprints prepared by architects. See §1.263A–1(b)(11).

(3) Costs required to be capitalized by producers—(i) In general. Except as specifically provided in section 263A(f), with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in section 263A(f)(4)(B)).

(ii) Pre-production costs. If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.

(iii) Post-production costs. Generally, producers must capitalize all indirect costs incurred subsequent to completion of production that are properly allocable to the property produced. Thus, for example, storage and handling costs incurred while holding the property produced for sale after production must be capitalized to the property to the extent properly allocable to the property. However, see §1.263A–3(c) for exceptions.

(4) Practical capacity concept. Notwithstanding any provision to the contrary, the use, directly or indirectly, of the practical capacity concept is not permitted under section 263A. For purposes of section 263A, the term practical capacity concept means any concept, method, procedure, or formula.
(such as the practical capacity concept described in §1.471-11(d)(4)) whereunder fixed costs are not capitalized because of the relationship between the actual production at the taxpayer’s production facility and the practical capacity of the facility. For purposes of this section, the practical capacity of a facility includes either the practical capacity or theoretical capacity of the facility, as defined in §1.471-11(d)(4), or any similar determination of productive or operating capacity. The practical capacity concept may not be used with respect to any activity to which section 263A applies (i.e., production or resale activities). A taxpayer shall not be considered to be using the practical capacity concept solely because the taxpayer properly does not capitalize costs described in §1.263A-1(e)(3)(iii)(E), relating to certain costs attributable to temporarily idle equipment.

(5) Taxpayers required to capitalize costs under this section. This section generally applies to taxpayers that produce property. If a taxpayer is engaged in both production activities and resale activities, the taxpayer applies the principles of this section as if it read production or resale activities, and by applying appropriate principles from §1.263A-3. If a taxpayer is engaged in both production and resale activities, the taxpayer may elect the simplified production method provided in this section, but generally may not elect the simplified resale method discussed in §1.263A-3(d). If elected, the simplified production method must be applied to all eligible property produced and all eligible property acquired for resale by the taxpayer.

(b) Simplified production method—(1) Introduction. This paragraph (b) provides a simplified method for determining the additional section 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

(2) Eligible property—(i) In general. Except as otherwise provided in paragraph (b)(2)(ii) of this section, the simplified production method, if elected for any trade or business of a producer, must be used for all production and resale activities associated with any of the following categories of property to which section 263A applies:

(A) Inventory property. Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) Non-inventory property held for sale. Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business.

(C) Certain self-constructed assets. Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business.

(D) Self-constructed tangible personal property produced on a routine and repetitive basis—(i) In general. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer’s trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer’s trade or business when units of tangible personal property (as defined in §1.263A-10(c)) are mass-produced, that is, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and either the applicable recovery period of the property determined under section 168(c) is not longer than 3 years or the property is a material or supply that will be used and consumed within 3 years of being produced. For purposes of this paragraph (b)(2)(i)(D), the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of §1.168(c). Subsequent changes to the applicable recovery period of the assets will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph (b)(2)(i)(D).

(ii) Examples. The following examples illustrate this paragraph (b)(2)(i)(D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces...
numerous substantially identical dies and molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c). Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y's business for purposes of this paragraph because the dies and molds are both mass-produced and have a recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(c). The poles are not produced on a routine and repetitive basis in the ordinary course of Z's business for purposes of this paragraph because the poles have an applicable recovery period that is longer than 3 years.

(ii) Election to exclude self-constructed assets. At the taxpayer's election, the simplified production method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (b)(2)(i) (A) and (B) of this section. Taxpayers electing to exclude the self-constructed assets, defined in paragraphs (b)(2)(i) (C) and (D) of this section, from application of the simplified production method must, however, allocate additional section 263A costs to such property in accordance with §1.263A–1 (f).

(3) Simplified production method without historic absorption ratio election—(i) General allocation formula—(A) In general. Except as otherwise provided in paragraph (b)(3)(iv) of this section, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the simplified production method are computed as follows:

\[
\text{Absorption ratio} \times \text{section 471 costs remaining on hand at year end}
\]

(B) Effect of allocation. The absorption ratio generally is multiplied by the section 471 costs remaining in ending inventory or otherwise on hand at the end of each taxable year in which the simplified production method is applied. The resulting product is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized. See, however, paragraph (b)(3)(iii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A–1 or 1.263A–3, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified production method of this paragraph (b) are treated as inventory costs for all purposes of the Internal Revenue Code.

(ii) Definitions—(A) Absorption ratio. Under the simplified production method, the absorption ratio is determined as follows:

\[
\frac{\text{Additional section 263A costs incurred during the taxable year}}{\text{Section 471 costs incurred during the taxable year}}
\]

(1) Additional section 263A costs incurred during the taxable year. Additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in §1.263A–1(d)(3) that a taxpayer incurs during its current taxable year.

(2) Section 471 costs incurred during the taxable year. Section 471 costs incurred during the taxable year are defined as the section 471 costs described in §1.263A–1(d)(2) that a taxpayer incurs during its current taxable year.

(B) Section 471 costs remaining on hand at year end. Section 471 costs remaining
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on hand at year end means the section 471 costs, as defined in §1.263A–1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (b)(3)(iii) of this section.

(iii) LIFO taxpayers electing the simplified production method—(A) In general. Under the simplified production method, a taxpayer using a LIFO method must calculate a particular year’s index (e.g., under §1.472–8(e)) without regard to its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) LIFO increment. If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section 471 costs). The taxpayer then multiplies this amount by the absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer’s increment for the year stated in terms of section 471 costs.

(C) LIFO decrement. If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iv) De minimis rule for producers with total indirect costs of $200,000 or less—(A) In general. If a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero. Solely for purposes of this paragraph (b)(3)(iv), taxpayers are permitted to exclude any category of indirect costs (listed in §1.263A–1(e)(3)(iii)) that is not required to be capitalized (e.g., selling and distribution costs) in determining total indirect costs.

(B) Related party and aggregation rules. In determining whether the producer incurs $200,000 or less of total indirect costs in a taxable year, the related party and aggregation rules of §1.263A–3(b)(3) are applied by substituting total indirect costs for gross receipts wherever gross receipts appears.

(v) Examples. The provisions of this paragraph (b) are illustrated by the following examples.

Example 1. FIFO inventory method. (i) Taxpayer J uses the FIFO method of accounting for inventories. J’s beginning inventory for 1994 (all of which is sold during 1994) is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). The additional section 263A costs are allocated to the selling, general, and administrative expenses account in the income statement. J’s additional section 263A costs include capitalizable mixed service costs computed under the simplified service cost method as well as other allocable costs. J’s section 471 costs remaining in ending inventory at the end of 1994 are $500,000. J computes its absorption ratio for 1994, as follows:

\[
\text{Additional section 263A costs incurred during 1994} \quad \text{Section 471 costs incurred during 1994} = \frac{1,000,000}{500,000} = 20\%
\]
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(ii) Under the simplified production method, J determines the additional section 263A costs allocable to its ending inventory by multiplying the absorption ratio by the section 471 costs remaining in its ending inventory:

\[
\text{Additional section 263A costs} = 10\% \times \$3,000,000 = \$300,000
\]

(iii) J adds this $300,000 to the $3,000,000 of section 471 costs remaining in its ending inventory to calculate its total ending inventory of $3,300,000. The balance of J’s additional section 263A costs incurred during 1994, $700,000, ($1,000,000 less $300,000) is taken into account in 1994 as part of J’s cost of goods sold.

Example 2. LIFO inventory method. (i) Taxpayer K uses a dollar-value LIFO inventory method. K’s beginning inventory for 1994 is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, K incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. K’s 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) To determine the additional section 263A costs allocable to its ending inventory, K multiplies the 10% absorption ratio ($1,000,000 of additional section 263A costs divided by $10,000,000 of section 471 costs) by the $1,000,000 LIFO increment. Thus, K’s additional section 263A costs allocable to its ending inventory are $100,000 ($1,000,000 multiplied by 10%). This $100,000 is added to the $3,000,000 to determine a total 1994 LIFO increment of $1,100,000. K’s ending inventory is $3,600,000 (its beginning inventory of $2,500,000 plus the $1,100,000 increment). The balance of K’s additional section 263A costs incurred during 1994, $900,000 ($1,000,000 less $100,000), is taken into account in 1994 as part of K’s cost of goods sold.

(iii) In 1995, K sells one-half of the inventory in its 1994 LIFO increment. K must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, $50,000 (one-half of the total section 263A costs capitalized in 1994 ending inventory, or $100,000).

Example 3. LIFO pools. (i) Taxpayer U begins its business in 1994 and adopts the LIFO inventory method. During 1994, L incurs $10,000 of section 471 costs and $1,000 of additional section 263A costs. At the end of 1994, L’s ending inventory includes $3,000 of section 471 costs contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified production method, L computes its absorption ratio and inventory for 1994 as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>X</th>
<th>Y</th>
<th>Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994:</td>
<td></td>
<td>$3,000</td>
<td>$1,600</td>
<td>$600</td>
</tr>
<tr>
<td>Ending section 471 costs</td>
<td>300</td>
<td>160</td>
<td>60</td>
<td>80</td>
</tr>
<tr>
<td>Additional section 263A costs (10%)</td>
<td>300</td>
<td>160</td>
<td>60</td>
<td>80</td>
</tr>
<tr>
<td>1994 ending inventory</td>
<td>$3,300</td>
<td>$1,760</td>
<td>$660</td>
<td>$880</td>
</tr>
</tbody>
</table>

(ii) During 1995, L incurs $2,000 of section 471 costs as shown below and $400 of additional section 263A costs. Moreover, L sells goods from pools X, Y, and Z having a total cost of $1,000. L computes its absorption ratio and inventory for 1995:

\[
\text{Additional section 263A costs incurred during 1995} = \frac{\$400}{\$2,000} = 20\%
\]
(iii) In 1995, L experiences a $200 decrement in pool Z. Thus, L must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995’s cost of goods sold. To do so, L determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($300 divided by $800, or 25%). L then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by L in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) Simplified production method with historic absorption ratio election—(i) In general. This paragraph (b)(4) generally permits producers using the simplified production method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraphs (b)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified production method for three or more consecutive taxable years immediately prior to the year of election and has capitalized additional section 263A costs using an actual absorption ratio (as defined under paragraph (b)(3)(ii) of this section) for its three most recent consecutive taxable years. This method is not available to a taxpayer that is deemed to have zero additional section 263A costs under paragraph (b)(3)(iv) of this section. The historic absorption ratio is used in lieu of an actual absorption ratio computed under paragraph (b)(3)(ii) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for each taxable year within the qualifying period described in paragraph (b)(4)(ii)(C) of this section.

(ii) Operating rules and definitions—
(A) Historic absorption ratio. (1) The historic absorption ratio is equal to the following ratio:

\[
\text{Additional section 263A costs incurred during the test period} \div \text{Section 471 costs incurred during the test period}
\]

(2) Additional section 263A costs incurred during the test period are defined as the additional section 263A costs described in §1.263A–1(d)(3) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(3) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A–1(d)(2) that

---

### Table: Costs and Decrement Calculation

<table>
<thead>
<tr>
<th>Year</th>
<th>Costs Description</th>
<th>X</th>
<th>Y</th>
<th>Z</th>
<th>Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995:</td>
<td>Beginning section 471 costs</td>
<td>$3,000</td>
<td>$1,600</td>
<td>$600</td>
<td>$800</td>
</tr>
<tr>
<td></td>
<td>1995 section 471 costs</td>
<td>2,000</td>
<td>1,500</td>
<td>300</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>Section 471 costs of goods sold</td>
<td>(1,000)</td>
<td>(300)</td>
<td>(300)</td>
<td>(400)</td>
</tr>
<tr>
<td></td>
<td>1995 ending section 471 costs</td>
<td>$4,000</td>
<td>$2,800</td>
<td>$600</td>
<td>$600</td>
</tr>
<tr>
<td>Consisting of:</td>
<td>1994 layer</td>
<td>$2,800</td>
<td>$1,600</td>
<td>$600</td>
<td>$600</td>
</tr>
<tr>
<td></td>
<td>1995 layer</td>
<td>1,200</td>
<td>1,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$4,000</td>
<td>$2,800</td>
<td>$600</td>
<td>$600</td>
</tr>
<tr>
<td>Additional section 263A costs:</td>
<td>1994 (10%)</td>
<td>$280</td>
<td>$160</td>
<td>$60</td>
<td>$60</td>
</tr>
<tr>
<td></td>
<td>1995 (20%)</td>
<td>240</td>
<td>240</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$520</td>
<td>$400</td>
<td>$60</td>
<td>$60</td>
</tr>
<tr>
<td></td>
<td>1995 ending inventory</td>
<td>$4,520</td>
<td>$3,200</td>
<td>$660</td>
<td>$660</td>
</tr>
</tbody>
</table>
the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(B) Test period—(1) In general. The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(2) Updated test period. The test period begins again with the beginning of the first taxable year after the close of a qualifying period. This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period as defined in paragraph (b)(4)(i)(C) of this section.

(C) Qualifying period—(1) In general. A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period).

(2) Extension of qualifying period. In the first taxable year following the close of each qualifying period, (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual absorption ratio under the simplified production method. If the actual absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (i.e., the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual absorption ratios beginning with the recomputation year under the simplified production method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(ii) Method of accounting—(A) Adoption and use. The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified production method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (b)(4), provided the taxpayer has not obtained the Commissioner’s consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified production method in determining its section 263A costs. Accordingly, in computing its actual absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (b)(4), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual absorption ratio by reason of the requirements of this paragraph (b)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) Revocation of election. A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) Reporting and recordkeeping requirements—(A) Reporting. A taxpayer making an election under this paragraph (b)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual absorption ratios determined under the simplified production method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying
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period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (i.e., after an updated test period).

(B) Recordkeeping. A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) Transition rules. Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified production method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§1.263A–1 and 1.263A–3 had applied throughout the test period.

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

Example. (i) Taxpayer M uses the FIFO method of accounting for inventories and for 1994 elects to use the historic absorption ratio with the simplified production method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (b)(4)(v) of this section, M identifies the following costs incurred during the test period:

1991:
- Add'l section 263A costs—$100
- Section 471 costs—$3,000

1992:
- Add'l section 263A costs—$200
- Section 471 costs—$4,000

1993:
- Add'l section 263A costs—$300
- Section 471 costs—$5,000

(ii) Therefore, M computes a 5% historic absorption ratio determined as follows:

\[
\text{Historic absorption ratio} = \frac{100 + 200 + 300}{3,000 + 4,000 + 5,000} = \frac{600}{12,000} = 5\%
\]

(iii) In 1994, M incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified production method using a historic absorption ratio, M determines the additional section 263A costs allocable to its ending inventory by multiplying its historic absorption ratio (5%) by the section 471 costs remaining in its ending inventory as follows:

\[
\text{Additional section 263A costs} = 5\% \times 3,000 = 150
\]

(iv) To determine its ending inventory under section 263A, M adds the additional section 263A costs allocable to its ending inventory to its section 471 costs remaining in ending inventory ($150+$3,000). The balance of M’s additional section 263A costs incurred during 1994 is taken into account in 1994 as part of M’s cost of goods sold.

(v) M’s qualifying period ends with the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which M must compute its actual absorption ratio. M determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, M must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, M’s actual absorption ratio for 1999 were not between 4.5% and 5.5%, M’s qualifying period would end and M would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once M’s historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.
(c) Additional simplified methods for producers. The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(d) Cross reference. See §1.6001–1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

(e) Change in method of accounting—

(1) In general. A change in a taxpayer's treatment of additional section 263A costs to comply with paragraph (b)(2)(i)(D) of this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations under those sections apply. See §1.263A–7. For a taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (e)(2) through (5) of this section, for obtaining the advance consent of the Commissioner (for further guidance, for example, see Rev. Proc. 97–27 (1997–1 CB 680), as modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), as amplified and clarified by Rev. Proc. 2002–54 (2002–2 CB 432), and §601.601(d)(2)(1)(b) of this chapter). For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures, as modified by paragraphs (e)(3) and (4) of this section, for obtaining the Commissioner's advance consent to a change in accounting method.

(2) Scope limitations. Any limitations on obtaining the automatic consent or advance consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005.

(3) Audit protection. A taxpayer that changes its method of accounting in accordance with this paragraph (e) to comply with paragraph (b)(2)(i)(D) of this section does not receive audit protection if its method of accounting for additional section 263A costs is an issue under consideration at the time the application is filed with the national office.

(4) Section 481(a) adjustment. A change in method of accounting to conform to paragraph (b)(2)(i)(D) of this section requires a section 481(a) adjustment. The section 481(a) adjustment period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to paragraph (b)(2)(i)(D) of this section.

(5) Time for requesting change. Notwithstanding the provisions of §1.446–1(e)(3)(i) and any contrary administrative procedure, a taxpayer may submit a request for advance consent to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005, on or before the date that is 30 days after the
§ 1.263A-3 Rules relating to property acquired for resale.

(a) Capitalization rules for property acquired for resale—(1) In general. Section 263A applies to real property and personal property described in section 1221(1) acquired for resale by a retailer, wholesaler, or other taxpayer (re¬seller). However, section 263A does not apply to personal property described in section 1221(1) acquired for resale by a reseller whose average annual gross receipts for the three previous taxable years do not exceed $10,000,000 (small reseller). For this purpose, personal property includes both tangible and intangible property. Property acquired for resale includes stock in trade of the taxpayer or other property which is includible in the taxpayer’s inventory if on hand at the close of the taxable year, and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. See, however, §1.263A-1(b)(11) for an exception for certain de minimis property provided to customers incident to the provision of services.

(2) Resellers with production activities—(i) In general. Generally, a taxpayer must capitalize all direct costs and certain indirect costs associated with real property and tangible personal property it produces. See §1.263A-2(a). Thus, except as provided in paragraphs (a)(2)(ii) and (3) of this section, a reseller, including a small reseller, that also produces property must capitalize the additional section 263A costs associated with any property it produces.

(ii) Exception for small resellers. Under this paragraph (a)(2)(ii), a small reseller is not required to capitalize additional section 263A costs associated with any personal property that is produced incident to its resale activities, provided the production activities are de minimis (within the meaning of paragraph (a)(2)(iii) of this section).

(iii) De minimis production activities—(A) In general. (1) In determining whether a taxpayer’s production activities are de minimis, all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed de minimis if—

(i) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

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

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

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

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

(3) Resellers with property produced under contract. Generally, property produced for a taxpayer under a contract (within the meaning of §1.263A-2(a)(1)(i)(B)(2)) is treated as property produced by the taxpayer. See §1.263A-2(a)(1)(i)(B). However, a small reseller is not required to capitalize additional section 263A costs to personal property produced for it under contract with an
unrelated person if the contract is entered into incident to the resale activities of the small reseller and the property is sold to its customers. For purposes of this paragraph, persons are related if they are described in section 267(b) or 707(b).

(4) Use of the simplified resale method—

(i) In general. Except as provided in paragraphs (a)(4)(ii) and (iii) of this section, a taxpayer may elect the simplified production method (as described in §1.263A–2(b)) but may not elect the simplified resale method (as described in paragraph (d) of this section) if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in §1.263A–2(b)(2).

(ii) Resellers with de minimis production activities. A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method if its production activities with respect to the items of eligible property listed in §1.263A–2(b)(2) are de minimis (within the meaning of paragraph (a)(2)(iii) of this section) and incident to its resale of personal property described in section 1221(1).

(iii) Resellers with property produced under a contract. A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. For purposes of this paragraph (a)(4)(iii), persons are related if they are described in section 267(b) or 707(b).

(iv) Application of simplified resale method. A taxpayer that uses the simplified resale method and has de minimis production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method.

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

(i) Test period for new taxpayers. For purposes of applying this exception, if a taxpayer has been in existence for less than three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

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

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

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

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

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

(A) Returns or allowances;

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

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

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

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

(F) Receipts from any activity other than a trade or business or an activity engaged in for profit.
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(3) Aggregation of gross receipts—(1) In general. In determining gross receipts, all persons treated as a single employer under section 52(a) or (b), section 414(m), or any regulation prescribed under section 414 (or persons that would be treated as a single employer under any of these provisions if they had employees) shall be treated as one taxpayer. The gross receipts of a single employer (or the group) are determined by aggregating the gross receipts of all persons (or the members of the group, excluding any gross receipts attributable to transactions occurring between group members.

(ii) Single employer defined. A controlled group, which is treated as a single employer under section 52(a), includes members of a controlled group within the meaning of section 1563(a), regardless of whether such members would be treated as component members of such group under section 1563(b). (See §1.52–1(c).) Thus, for example, the gross receipts of a franchised corporation that is treated as an excluded member for purposes of section 1563(b) are included in the single employer's gross receipts under this aggregation rule, if such corporation and the taxpayer were members of the same controlled group under section 1563(a).

(iii) Gross receipts of a single employer. The gross receipts of a single employer for the test period do not, however, include the gross receipts of any member that was a group member (including any predecessor) for any or all of the three preceding taxable years. The gross receipts of the single employer for the test period do not, however, include the gross receipts of any member that was a group member (including any predecessor) for any or all of the three preceding taxable years, and is no longer a group member as of the first day of the taxable year in issue. Any group member that has a taxable year of less than 12 months must annualize its gross receipts in accordance with paragraph (b)(1)(ii) of this section.

(iv) Examples. The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. Subsidiary acquired during the taxable year. A parent corporation, (P), has owned 100% of the stock of another corporation, (S1), continually since 1989. P and S1 are calendar year taxpayers. S1 acquired property for resale. On January 1, 1994, P acquires 100% of the stock of another calendar year corporation (S2). In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, the gross receipts of P, S1, and S2 for 1991, 1992, and 1993 are aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the three corporations.

Example 2. Subsidiary sold during the taxable year. Since 1989, a parent corporation, (P), has continually owned 100% of the stock of two other corporations, (S1) and (S2). The three corporations are calendar year taxpayers. S1 acquires property for resale. On December 31, 1993, P sells all of its stock in S2. In determining whether S1’s resale activities are subject to the provisions of section 263A for 1994, only the gross receipts of P and S1 for 1991, 1992, and 1993 must be aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the two corporations.

(c) Purchasing, handling, and storage costs—(1) In general. Generally, §1.263A-1(e) describes the types of costs that must be capitalized by taxpayers. Resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in §1.263A–1(e)(3), which are properly allocable to property acquired for resale. The indirect costs most often incurred by resellers are purchasing, handling, and storage costs. This paragraph (c) provides additional guidance regarding each of these categories of costs. As provided in §1.263A–1(e), this paragraph (c) also applies to producers incurring purchasing, handling, and storage costs.

(2) Costs attributable to purchasing, handling, and storage activities generally consist of direct and indirect labor costs (including the costs of pension plans and other fringe benefits); occupancy expenses including rent, depreciation, insurance, security, taxes, utilities and maintenance; materials and supplies; rent, maintenance, depreciation, and insurance of vehicles and equipment; tools; telephone; travel; and the general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities.
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(3) Purchasing costs—(i) In general. Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs (e.g., of buyers, assistant buyers, and clerical workers), relating to—
(A) The selection of merchandise;
(B) The maintenance of stock assortment and volume;
(C) The placement of purchase orders;
(D) The establishment and maintenance of vendor contacts; and
(E) The comparison and testing of merchandise.

(ii) Determination of whether personnel are engaged in purchasing activities. The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person’s title or job classification. Thus, for example, although an employee’s job function may be described in such a way as to indicate activities outside the area of purchasing (e.g., a marketing representative), such activities must be analyzed on the basis of the activities performed by that employee. If a person performs both purchasing and non-purchasing activities, the taxpayer must reasonably allocate the person’s labor costs between these activities. For example, a reasonable allocation is one based on the amount of time the person spends on each activity.
(A) ½–2/3 rule for allocating labor costs. A taxpayer may elect the ½–2/3 rule for allocating labor costs of persons performing both purchasing and non-purchasing activities. If elected, the taxpayer must allocate the labor costs of all such persons using the ½–2/3 rule. Under this rule—
(1) If less than one-third of a person’s activities are related to purchasing, none of that person’s labor costs are allocated to purchasing;
(2) If more than two-thirds of a person’s activities are related to purchasing, all of that person’s labor costs are allocated to purchasing; and
(3) In all other cases, the taxpayer must reasonably allocate labor costs between purchasing and non-purchasing activities.

(B) Example. The application of paragraph (c)(3)(ii)(A) of this section may be illustrated by the following example:

Example. Taxpayer O is a reseller that employs three persons, A, B, and C, who perform both purchasing and non-purchasing activities. These persons spend the following time performing purchasing activities: A-25 %; B-70 %; and C-50 %. Under the ½–2/3 rule, Taxpayer O treats none of A’s labor costs as purchasing costs, all of B’s labor costs as purchasing costs, and Taxpayer O allocates 50 % of C’s labor costs as purchasing costs.

(4) Handling costs—(i) In general. Handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in §1.263A–2(a)(1). Handling costs are generally required to be capitalized under section 263A. Under this paragraph (c)(4)(i), however, handling costs incurred at a retail sales facility (as defined in paragraph (c)(5)(ii)(B) of this section) with respect to property sold to retail customers at the facility are not required to be capitalized. Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized. In addition, handling costs incurred at a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the ratio in paragraph (c)(5)(ii)(B) of this section.

(ii) Processing costs. Processing costs are the costs a reseller incurs in making minor changes or alterations to the nature or form of a product acquired for resale. Minor changes to a product include, for example, monogramming a sweater, altering a pair of pants, and other similar activities.

(iii) Assembling costs. Generally, assembling costs are costs associated with incidental activities that are necessary in readying property for resale
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(e.g., attaching wheels and handlebars to a bicycle acquired for resale).

(iv) Repackaging costs. Repackaging costs are the costs a taxpayer incurs to package property for sale to its customers.

(v) Transportation costs. Generally, transportation costs are the costs a taxpayer incurs moving or shipping property acquired for resale. These costs include the cost of dispatching trucks; loading and unloading shipments; and sorting, tagging, and marking property. Transportation costs may consist of depreciation on trucks and equipment and the costs of fuel, insurance, labor, and similar costs. Generally, transportation costs required to be capitalized include costs incurred in transporting property—

(A) From the vendor to the taxpayer;

(B) From one of the taxpayer’s storage facilities to another of its storage facilities;

(C) From the taxpayer’s storage facility to its retail sales facility;

(D) From the taxpayer’s retail sales facility to its storage facility; and

(E) From one of the taxpayer’s retail sales facilities to another of its retail sales facilities.

(vi) Costs not required to be capitalized as handling costs—

(A) Distribution costs—(1) In general. Distribution costs are not required to be capitalized. Distribution costs are any transportation costs incurred outside a storage facility in delivering goods to a customer. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility.

(2) Costs incurred in transporting goods to a related person. Distribution costs do not include costs incurred by a taxpayer in delivering goods to a related person. Thus, for example, when a taxpayer sells goods to a related person, the costs of transporting the goods are included in determining the basis of the goods that are sold, and hence in determining the resulting gain or loss from the sale, for all purposes of the Internal Revenue Code and the regulations thereunder. See, e.g., sections 267, 707, and 1502. For purposes of this provision, persons are related if they are described in section 267(b) or section 707(b).

(B) Delivery of custom-ordered items. Generally, costs incurred in transporting goods from a taxpayer’s storage facility to its retail sales facility must be capitalized. However, costs incurred outside a storage facility in delivering custom-ordered items to a retail sales facility are not required to be capitalized. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility. Delivery of custom-ordered items occurs when a taxpayer can demonstrate that a delivery to the taxpayer’s retail sales facility is made to fill an identifiable order of a particular customer (placed by the customer before the delivery of the goods occurs) for the particular goods in question. Factors that may demonstrate the existence of a specific, identifiable delivery include the following—

(1) The customer has paid for the item in advance of the delivery;

(2) The customer has submitted a written order for the item;

(3) The item is not normally available at the retail sales facility for onsite customer purchases; and

(4) The item will be returned to the storage facility (and not held for sale at the retail sales facility) if the customer cancels an order.

(C) Pick and pack costs—(1) In general. Generally, handling costs incurred inside a storage or warehousing facility must be capitalized. However, costs attributable to pick and pack activities inside a storage or warehousing facility are not required to be capitalized. Pick and pack activities are activities undertaken in preparation for imminent shipment to a particular customer after the customer has ordered the specific goods in question. Examples of pick and pack activities include:

(i) Moving specific goods from a storage location in preparation for shipment to the customer;

(ii) Packing or repacking those goods for shipment to the customer; and

(iii) Staging those goods for shipment to the customer.

(2) Activities that are not pick and pack activities. Pick and pack activities do not include:

(i) Unloading goods that are received for storage;
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(2) Thus, for example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

(C) An integral part of a retail sales facility. A storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility.

(D) On-site sales. On-site sales are defined as sales made to retail customers physically present at a facility. For example, mail order and catalog sales are made to customers not physically present at the facility, and thus, are not on-site sales.

(E) Retail customer—(I) In general. A retail customer is defined as the final purchaser of the merchandise. A retail customer does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers. (2) Certain non-retail customers treated as retail customers. For purposes of this section, a non-retail customer is treated as a retail customer with respect to a particular facility if the following requirements are satisfied—

(i) The non-retail customer purchases goods under the same terms and conditions as are available to retail customers (e.g., no special discounts);

(ii) The non-retail customer purchases goods in the same manner as a retail customer (e.g., the non-retail customer may not place orders in advance and must come to the facility to examine and select goods);

(iii) Retail customers shop at the facility on a routine basis (i.e., on most business days), and no special days or hours are reserved for non-retail customers; and

(iv) More than 50 percent of the gross sales of the facility are made to retail customers.
(F) **Off-site storage facility.** An off-site storage facility is defined as a storage facility that is not an on-site storage facility.

(G) **Dual-function storage facility.** A dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. For example, a dual-function storage facility would include a regional warehouse that serves the taxpayer’s separate retail sales outlets and also contains a sales outlet therein. A dual-function storage facility also includes any facility where sales are made to retail customers in on-site sales and to—

1. (I) Retail customers in sales that are not on-site sales; or
2. (II) Other customers.

(iii) Treatment of storage costs incurred at a dual-function storage facility—(A) In general. Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function. To the extent that the dual-function storage facility’s storage costs are allocable to the off-site storage function, they must be capitalized. To the extent that the dual-function storage facility’s storage costs are allocable to the on-site storage function, they are not required to be capitalized.

(B) Dual-function storage facility allocation ratio—(1) In general. Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function using the ratio of—

(i) Gross on-site sales of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored therein); to

(ii) Total gross sales of the facility. For this purpose, the total gross sales of the facility include the value of items shipped to other facilities of the taxpayer.

(2) Illustration of ratio allocation. For example, if a dual-function storage facility’s on-site sales are 40 percent of the total gross sales of the facility, then 40 percent of the facility’s storage costs are allocable to the on-site storage function and are not required to be capitalized under section 263A.

(3) **Appropriate adjustments for other uses of a dual-function storage facility.** Prior to computing the allocation ratio in paragraph (c)(5)(i)(B) of this section, a taxpayer must apply the principles of paragraph (c)(5)(iv) of this section in determining the portion of the facility that is a dual-function storage facility (and the costs attributable to such portion).

(C) **De minimis 90–10 rule for dual-function storage facilities.** If 90 percent or more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility.

(iv) Costs not attributable to an off-site storage facility. To the extent that costs incurred at an off-site storage facility are not properly allocable to the taxpayer’s storage function, the costs are not accounted for as off-site storage costs. For example, if a taxpayer has an office attached to its off-site storage facility where work unrelated to the storage function is performed, such as a sales office, costs associated with this office are not off-site storage costs. However, if a taxpayer uses a portion of an off-site storage facility in a manner related to the storage function, for example, to store equipment or supplies that are not offered for sale to customers, costs associated with this portion of the facility are off-site storage costs.

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

Example 1. Catalog or mail order center. Taxpayer P operates a mail order catalog business. As part of its business, P stores merchandise for shipment to customers who purchase the merchandise through orders placed by telephone or mail. P’s storage facility is not an on-site storage facility because no on-site sales are made at the facility.

Example 2. Pooled-stock facility. Taxpayer Q maintains a pooled-stock facility, which functions as a back-up regional storage facility for Q’s retail sales outlets in the nearby area. Q’s pooled stock facility is an off-site
storage facility because it is neither physically attached to nor an integral part of a retail sales facility.

Example 3. Wholesale warehouse. Taxpayer R operates a wholesale warehouse where wholesale sales are made to customers physically present at the facility. R's customers resell the goods they purchase from R to final retail customers. Because no retail sales are conducted at the facility, all storage costs attributable to R's wholesale warehouse must be capitalized.

(d) Simplified resale method—(1) Introduction. This paragraph (d) provides a simplified method for determining the additional section 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.

(2) Eligible property. Generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. However, certain resellers with property produced as a result of de minimis production activities or property produced under contract may elect the simplified resale method, as described in paragraph (a)(4) of this section. Eligible property for purposes of the simplified resale method, therefore, includes any real or personal property described in section 1221(1) that is acquired for resale and any eligible property (within the meaning of §1.263A-2(b)(2)) that is described in paragraph (a)(4) of this section.

(3) Simplified resale method without historic absorption ratio election—(1) General allocation formula—(A) In general. Under the simplified resale method, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are computed as follows:

\[
\text{Combined absorption ratio} \times \text{section 471 costs remaining on hand at year end}
\]

(B) Effect of allocation. The resulting product under the general allocation formula is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized.

(C) Definitions—(1) Combined absorption ratio. The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio as defined in paragraph (d)(3)(i)(D) of this section and the purchasing costs absorption ratio as defined in paragraph (d)(3)(i)(E) of this section.

(2) Section 471 costs remaining on hand at year end. Section 471 costs remaining on hand at year end mean the section 471 costs, as defined in §1.263A-1(d)(2), that the taxpayer incurs during its current taxable year, which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (d)(3)(ii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A-1 or 1.263A-2, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified resale method of this paragraph (d) are treated as inventory costs for all purposes of the Internal Revenue Code.

(D) Storage and handling costs absorption ratio. (1) Under the simplified resale method, the storage and handling costs absorption ratio is determined as follows:

\[
\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}}
\]
Current year's purchasing costs

\[
\frac{\text{Current year's purchases}}{\text{Current year's purchasing costs}}
\]
costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) LIFO increment. If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section 471 costs). The taxpayer then multiplies this amount by the combined absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer’s increment for the year stated in terms of section 471 costs.

(C) LIFO decrement. If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iii) Permissible variations of the simplified resale method. The following variations of the simplified resale method are permitted:

(A) The exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula in paragraph (d)(3)(i)(D) of this section; or

(B) Multiplication of the storage and handling costs absorption ratio in paragraph (d)(3)(i)(D) of this section by the total of section 471 costs included in a LIFO taxpayer’s ending inventory (rather than just the increment, if any, experienced by the LIFO taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs.

(iv) Examples. The provisions of this paragraph (d)(3) are illustrated by the following examples:

Example 1. FIFO inventory method. (i) Taxpayer S uses the FIFO method of accounting for inventories. S’s beginning inventory for 1994 (all of which was sold during 1994) was $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, S makes purchases of $10,000,000. In addition, S incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. S’s purchases (section 471 costs) remaining in ending inventory at the end of 1994 are $3,000,000.

(ii) In 1994, S incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, S incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—$40,000 ($100,000 divided by $1,000,000) multiplied by $400,000); storage—$80,000 ($200,000 divided by $1,000,000) multiplied by $400,000); and handling—$80,000 ($200,000 divided by $1,000,000) multiplied by $400,000).

(iii) S computes its purchasing costs absorption ratio for 1994 as follows:

\[
\frac{1994 \text{ purchasing costs}}{1994 \text{ purchases}} = \frac{$460,000 + $40,000}{$10,000,000} = \frac{$500,000}{$10,000,000} = 5.0\%
\]
(iv) S computes its storage and handling costs absorption ratio for 1994 as follows:

\[
\text{Storage and handling costs absorption ratio for 1994} = \frac{\text{Beginning inventory plus 1994 purchases}}{\text{Beginning inventory plus 1994 purchases}}
\]

\[
= \frac{\$110,000 + \$80,000 + \$90,000 + \$80,000}{\$2,000,000 + \$10,000,000}
\]

\[
= \frac{\$190,000 + \$170,000}{\$12,000,000}
\]

\[
= \frac{\$360,000}{\$12,000,000}
\]

\[
= 3.0\%
\]

(v) S's combined absorption ratio is 8.0 %, or the sum of the purchasing costs absorption ratio (5.0 %) and the storage and handling costs absorption ratio (3.0 %). Under the simplified resale method, S determines the additional section 263A costs allocable to its ending inventory by multiplying the combined absorption ratio by its section 471 costs with respect to current year's purchases remaining in ending inventory:

\[
\text{Additional section 263A costs} = 8.0\% \times \$3,000,000 = \$240,000
\]

(vi) S adds this $240,000 to the $3,000,000 of purchases remaining in its ending inventory to determine its total ending FIFO inventory of $3,240,000.

Example 2. LIFO inventory method. (i) Taxpayer T uses a dollar-value LIFO inventory method. T's beginning inventory for 1994 is $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, T makes purchases of $10,000,000. In addition, T incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. T's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) In 1994, T incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, T incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—$40,000 ($100,000 divided by $1,000,000) multiplied by $400,000; storage—$80,000 ($200,000 divided by $1,000,000) multiplied by $400,000; and handling—$80,000 ($200,000 divided by $1,000,000) multiplied by $400,000).

(iii) Based on these facts, T determines that it has a combined absorption ratio of 8.0 %. To determine the additional section 263A costs allocable to its ending inventory, T multiplies its combined absorption ratio (8.0 %) by the $1,000,000 LIFO increment. Thus, T's additional section 263A costs allocable to its ending inventory are $80,000 ($1,000,000 multiplied by 8.0 %). This $80,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,080,000. T's ending inventory is $3,180,000 (its beginning inventory of $2,100,000 plus the $1,080,000 increment).

(iv) In 1995, T sells one-half of the inventory in its 1994 LIFO increment. T must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, i.e., one-half of the $80,000 additional section 263A costs capitalized in 1994 ending inventory, or $40,000.

Example 3. LIFO Pools. (i) Taxpayer U begins its business in 1994, and adopts the LIFO inventory method. During 1994, U makes purchases of $10,000, and incurs $400 of purchasing costs, $350 of storage costs and $250 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper allocable share of mixed service costs.

(ii) U computes its purchasing costs absorption ratio for 1994, as follows:
(iii) U computes its storage and handling costs absorption ratio for 1994, as follows:

\[
\frac{1994 \text{ storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{$350 + $250}{0 + $10,000} = \frac{$600}{10,000} = 6.0\%
\]

(iv) U’s combined absorption ratio is 10%, or the sum of the purchasing costs absorption ratio (4.0%) and the storage and handling costs absorption ratio (6.0%). At the end of 1994, U’s ending inventory included $3,000 of current year purchases, contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified resale method, U computes its ending inventory for 1994 as follows:

\[
\begin{align*}
\text{1994 Total} & \quad \text{X} & \quad \text{Y} & \quad \text{Z} \\
\text{Ending section 471 costs} & \quad $3,000 & \quad $1,600 & \quad $600 & \quad $800 \\
\text{Additional section 263A costs (10\%)} & \quad 300 & \quad 160 & \quad 60 & \quad 80 \\
\text{1994 ending inventory} & \quad 3,300 & \quad 1,760 & \quad 660 & \quad 880
\end{align*}
\]

(v) During 1995, U makes purchases of $2,000 as shown below, and incurs $200 of purchasing costs, $325 of storage costs and $175 of handling costs. U’s purchasing costs, storage costs, and handling costs include their proper share of mixed service costs. Moreover, U sold goods from pools X, Y, and Z having a total cost of $1,000. U computes its ending inventory for 1995 as follows.

(vi) U computes its purchasing costs absorption ratio for 1995:

\[
\frac{1995 \text{ purchasing costs}}{1995 \text{ purchases}} = \frac{$200}{$2,000} = 10.0\%
\]

(vii) U computes its storage and handling costs absorption ratio for 1995:

\[
\frac{1995 \text{ storage and handling costs}}{\text{Beginning inventory plus 1995 purchases}} = \frac{$325 + $175}{3,000 + $2,000} = \frac{$500}{5,000} = 10.0\%
\]

(viii) U’s combined absorption ratio is 20.0%, or the sum of the purchasing costs absorption ratio (10.0%) and the storage and handling costs absorption ratio (10.0%).
<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>X</th>
<th>Y</th>
<th>Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning section 471 costs</td>
<td>$3,000</td>
<td>$1,600</td>
<td>$600</td>
<td>$800</td>
</tr>
<tr>
<td>1995 section 471 costs</td>
<td>2,000</td>
<td>1,500</td>
<td>300</td>
<td>200</td>
</tr>
<tr>
<td>Section 471 cost of goods sold</td>
<td>(1,000)</td>
<td>(300)</td>
<td>(300)</td>
<td>(400)</td>
</tr>
<tr>
<td>1995 ending section 471 costs</td>
<td>4,000</td>
<td>2,800</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Consisting of:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994 layer</td>
<td>2,800</td>
<td>1,600</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>1995 layer</td>
<td>1,200</td>
<td>1,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional section 263A costs:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994 (10%)</td>
<td>280</td>
<td>160</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>1995 (20%)</td>
<td>240</td>
<td>240</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995 ending inventory</td>
<td>4,520</td>
<td>3,200</td>
<td>660</td>
<td>660</td>
</tr>
</tbody>
</table>

(ix) In 1995, U experiences a $200 decrement in Pool Z. Thus, U must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995’s cost of goods sold. To do so, U determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). Then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by U in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) Simplified resale method with historic absorption ratio election—(i) In general. This paragraph (d)(4) permits resellers using the simplified resale method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (d)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified resale method for three or more consecutive taxable years immediately prior to the year of election. The historic absorption ratio is used in lieu of an actual combined absorption ratio computed under paragraph (d)(3)(i)(C)(1) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for the qualifying period described in paragraph (d)(4)(ii)(C) of this section.

(ii) Operating rules and definitions—(A) Historic absorption ratio. (1) The historic absorption ratio is equal to the following ratio:

\[
\text{Historic absorption ratio} = \frac{\text{Additional section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period}}
\]

(2) Additional section 263A costs incurred during the test period are defined as the sum of the products of the combined absorption ratios (defined in paragraph (d)(3)(i)(C)(1) of this section) multiplied by a taxpayer’s section 471 costs incurred with respect to purchases, for each taxable year of the test period.

(3) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A-1(d)(2) that a taxpayer incurs generally with respect to its purchases during the test period described in paragraph (d)(4)(ii)(B) of this section.

(B) Test period—(1) In general. The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(2) Updated test period. The test period begins again with the beginning of the first taxable year after the close of a qualifying period (as defined in paragraph (d)(4)(ii)(C) of this section). This new test period, the updated test period, is the three taxable-year period...
beginning with the first taxable year after the close of the qualifying period.

(C) Qualifying period—(1) In general. A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or updated test period).

(2) Extension of qualifying period. In the first taxable year following the close of each qualifying period (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual combined absorption ratio under the simplified resale method. If the actual combined absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (i.e., the previous five taxable years), the qualifying period must be extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual combined absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual combined absorption ratios beginning with the recomputation year under the simplified resale method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(iii) Method of accounting—(A) Adoption and use. The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified resale method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (d)(4), provided the taxpayer has not obtained the Commissioner’s consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified resale method in determining its section 263A costs. Accordingly, in computing its actual combined absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (d)(4)(iii)(A), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual combined absorption ratio during an updated test period by reason of the requirements of this paragraph (d)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) Revocation of election. A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) Reporting and recordkeeping requirements—(A) Reporting. A taxpayer making an election under this paragraph (d)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual combined absorption ratios determined under the simplified resale method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (i.e., after an updated test period).

(B) Recordkeeping. A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year.
for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) Transition rules. Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified resale method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§1.263A–1 and 1.263A–2 had applied throughout the test period.

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

Example. (i) Taxpayer V uses the FIFO method of accounting for inventories and in 1994 elects to use the historic absorption ratio with the simplified resale method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (d)(4)(v) of this section, V identifies the following costs incurred during the test period:

<table>
<thead>
<tr>
<th>Year</th>
<th>Additional Section 263A Costs</th>
<th>Section 471 Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>$100</td>
<td>$3,000</td>
</tr>
<tr>
<td>1992</td>
<td>$200</td>
<td>$4,000</td>
</tr>
<tr>
<td>1993</td>
<td>$300</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Historic absorption ratio = \( \frac{100 + 200 + 300}{3000 + 4000 + 5000} = \frac{600}{12000} = 5\% \)

(ii) In 1994, V incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified resale method using a historic absorption ratio, V determines the additional section 263A costs allocable to its ending inventory by multiplying its historic ratio (5%) by the section 471 costs remaining in its ending inventory:

Additional section 263A costs = 5\% \times $3,000 = $150

(iv) To determine its ending inventory under section 263A, V adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($150 + $3,000). The balance of V's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of V's cost of goods sold.

(v) V's qualifying period ends as of the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which V must compute its actual combined absorption ratio. V determines its actual absorption ratio for 1999 to be 5.25\% and compares that ratio to its historic absorption ratio (5\%). Therefore, V must continue to use its historic absorption ratio of 5\% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, V's actual combined absorption ratio for 1999 were not between 4.5\% and 5.5\%, V's qualifying period would end and V would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once V's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

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

(e) Cross reference. See §1.6001–1(a) regarding the duty of taxpayers to keep
such records as are sufficient to establish the amount of gross income, deductions, etc.


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

(a) Introduction—(1) In general. This section provides guidance with respect to the application of section 263A to property produced in a farming business as defined in paragraph (a)(4) of this section. Except as otherwise provided by the rules of this section, the general rules of §§1.263A–1 through 1.263A–3 and §§1.263A–7 through 1.263A–15 apply to property produced in a farming business. A taxpayer that engages in the raising or growing of any agricultural or horticultural commodity, including both plants and animals, is engaged in the production of property. Section 263A generally requires the capitalization of the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of this property. The direct and indirect costs of producing plants or animals generally include preparatory costs allocable to the plant or animal and preproductive period costs of the plant or animal. Except as provided in paragraphs (a)(2) and (e) of this section, taxpayers must capitalize the costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

(2) Exception—(i) In general. Section 263A does not apply to the costs of producing plants with a preproductive period of 2 years or less or the costs of producing animals in a farming business, if the taxpayer is not—

(A) A corporation or partnership required to use an accrual method of accounting (accrual method) under section 447 in computing its taxable income from farming; or

(B) A tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3).

(ii) Tax shelter—(A) In general. A farming business is considered a tax shelter, and thus a taxpayer prohibited from using the cash method under section 448(a)(3), if the farming business is—

(1) A farming syndicate as defined in section 464(c); or

(2) A tax shelter, within the meaning of section 6662(d)(2)(C)(iii).

(B) Presumption. Marketed arrangements in which persons carry on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance, within the meaning of section 6662(d)(2)(C)(iii), if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(iii) Examples. The following examples illustrate the provisions of this paragraph (a)(2):

Example 1. Farmer A grows trees that have a preproductive period in excess of 2 years, and that produce an annual crop. Farmer A is not required by section 447 to use an accrual method or prohibited by section 448(a)(3) from using the cash method. Accordingly, Farmer A qualifies for the exception described in this paragraph (a)(2). Since the trees have a preproductive period in excess of 2 years, Farmer A must capitalize the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of the trees. Since the annual crop has a preproductive period of 2 years or less, Farmer A is not required to capitalize the costs of producing the crops.

Example 2. Assume the same facts as Example 1, except that Farmer A is required by section 447 to use an accrual method or prohibited by 448(a)(3) from using the cash method. Farmer A does not qualify for the exception described in this paragraph (a)(2). Farmer A is required to capitalize the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of the trees and crops.

(3) Costs required to be capitalized or inventoried under another provision. The exceptions from capitalization provided in paragraphs (a)(2), (d) and (e) of this section do not apply to any cost that is required to be capitalized or inventoried under another Internal Revenue Code or regulatory provision, such as section 263 or 471.

(4) Farming business—(1) In general. A farming business means a trade or business involving the cultivation of land or the raising or harvesting of any
agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than 6 years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. For purposes of this section, the term harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another. Similarly, merely buying and reselling plants or animals grown or raised entirely by another is not raising an agricultural or horticultural commodity. A taxpayer is engaged in raising a plant or animal, rather than the mere resale of a plant or animal, if the plant or animal is held for further cultivation and development prior to sale. In determining whether a plant or animal is held for further cultivation and development prior to sale, consideration will be given to all of the facts and circumstances, including: the value added by the taxpayer to the plant or animal through agricultural or horticultural processes; the length of time between the taxpayer’s acquisition of the plant or animal and the time that the taxpayer makes the plant or animal available for sale; and in the case of a plant, whether the plant is kept in the container in which purchased, replanted in the ground, or replanted in a series of larger containers as it is grown to a larger size.

(A) Plant. A plant produced in a farming business includes, but is not limited to, a fruit, nut, or other crop bearing tree, an ornamental tree, a vine, a bush, sod, and the crop or yield of a plant that will have more than one crop or yield raised by the taxpayer. Sea plants are produced in a farming business if they are tended and cultivated as opposed to merely caught or harvested.

(B) Animal. An animal produced in a farming business includes, but is not limited to, any stock, poultry or other bird, and fish or other sea life raised by the taxpayer. Thus, for example, the term animal may include a cow, chicken, emu, or salmon raised by the taxpayer. Fish and other sea life are produced in a farming business if they are raised on a fish farm. A fish farm is an area where fish or other sea life are grown or raised as opposed to merely caught or harvested.

(ii) Incidental activities—(A) In general. A farming business includes processing activities that are normally incidental to the growing, raising, or harvesting of agricultural or horticultural products. For example, a taxpayer in the trade or business of growing fruits and vegetables may harvest, wash, inspect, and package the fruits and vegetables for sale. Such activities are normally incidental to the raising of these crops by farmers. The taxpayer will be considered to be in the trade or business of farming with respect to the growing of fruits and vegetables and the processing activities incident to their harvest.

(B) Activities that are not incidental. Farming business does not include the processing of commodities or products beyond those activities that are normally incidental to the growing, raising, or harvesting of such products.

(iii) Examples. The following examples illustrate the provisions of this paragraph (a)(4):

Example 1. Individual A operates a retail nursery. Individual A has three categories of plants. The first category is comprised of plants that Individual A grows from seeds or cuttings. The second category is comprised of plants that Individual A purchases in containers and grows for a period of from several months to several years. Individual A replants some of these plants in the ground. The others are replanted in a series of larger containers as they grow. The third category is comprised of plants that are purchased by Individual A in containers. Individual A does not grow these plants to a larger size before making them available for resale. Instead, Individual A makes these plants available for resale, in the container in which purchased, shortly after receiving them. Thus, no value is added to these plants by Individual A through horticultural processes. Individual A also sells soil, mulch, chemicals, and yard tools. Individual A is producing property in the farming business with respect to the first two categories of plants because these plants are held for further cultivation and development prior to sale. The plants in the third category are not held for further cultivation and development prior to
sale and, therefore, are not regarded as property produced in a farming business for purposes of section 263A. Accordingly, Individual A must account for the third category of plants, along with the soil, mulch, chemicals, and yard tools, as property acquired for resale. If Individual A’s average annual gross receipts are less than $10 million, Individual A will not be required to capitalize costs with respect to its resale activities under section 263A.

Example 2. Individual B is in the business of growing and harvesting wheat and other grains. Individual B also processes grain that Individual B has harvested in order to produce breads, cereals, and other similar food products, which Individual B then sells to customers in the course of its business. Although Individual B is in the farming business with respect to the growing and harvesting of grain, Individual B is not in the farming business with respect to the processing of such grain to produce the food products.

Example 3. Individual C is in the business of raising poultry and other livestock. Individual C also operates a meat processing operation in which the poultry and other livestock are slaughtered, processed, and packaged or canned. The packaged or canned meat is sold to Individual C’s customers. Although Individual C is in the farming business with respect to the raising of poultry and other livestock, Individual C is not in the farming business with respect to the processing of such animals to produce the food products.

(b) Application of section 263A to property produced in a farming business—(1) In general. Unless otherwise provided in this section, section 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of any property in a farming business (including animals and plants without regard to the length of their preproductive period). Section 1.263A–1(e) describes the types of direct and indirect costs that generally must be capitalized by taxpayers under section 263A and paragraphs (b)(1)(i) and (ii) of this section provide specific examples of the types of costs typically incurred in the trade or business of farming. For purposes of this section, soil and water conservation expenditures that a taxpayer has elected to deduct under section 175 and fertilizer that a taxpayer has elected to deduct under section 180 are not subject to capitalization under section 263A, except to the extent these costs are required to be capitalized as a preproductive period cost of a plant or animal.

(i) Plants. The costs of producing a plant typically required to be capitalized under section 263A include the costs incurred so that the plant’s growing process may begin (preparatory costs), such as the acquisition costs of the seed, seedling, or plant, and the costs of planting, cultivating, maintaining, or developing the plant during the preproductive period (preproductive period costs). Preproductive period costs include, but are not limited to, management, irrigation, pruning, soil and water conservation (including costs that the taxpayer has elected to deduct under section 175), fertilizing (including costs that the taxpayer has elected to deduct under section 180), frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes (except state and Federal income taxes), and interest required to be capitalized under section 263A(f).

(ii) Animals. The costs of producing an animal typically required to be capitalized under section 263A include the costs incurred so that the animal’s raising process may begin (preparatory costs), such as the acquisition costs of the animal, and the costs of raising or caring for such animal during the preproductive period (preproductive period costs). Preproductive period costs include, but are not limited to, management, feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), maintaining pasture or pen areas (including costs that the taxpayer has elected to deduct under sections 175 or 180), breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, electricity, hired labor, tax depreciation and repairs on buildings and equipment used in raising the animals (for example, barns, trucks, and trailers), farm overhead, taxes (except state and Federal income taxes), and interest required to be capitalized under section 263A(f).
(2) Preproductive period—(1) Plant—(A) In general. The preproductive period of property produced in a farming business means—

(1) In the case of a plant that will have more than one crop or yield (for example, an orange tree), the period before the first marketable crop or yield from such plant;

(2) In the case of the crop or yield of a plant that will have more than one crop or yield (for example, the orange), the period before such crop or yield is disposed of; or

(3) In the case of any other plant, the period before such plant is disposed of.

(B) Applicability of section 263A. For purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States is based on the nationwide weighted average preproductive period for such plant. The Commissioner will publish a non-inclusive list of plants with a nationwide weighted average preproductive period in excess of 2 years. The nationwide weighted average preproductive period or the estimated preproductive period is only used for purposes of determining the period during which a taxpayer must capitalize preproductive period costs with respect to a particular plant.

(1) Beginning of the preproductive period. The actual preproductive period of a plant begins when the taxpayer first incurs costs that directly benefit or are incurred by reason of the plant. Generally, this occurs when the taxpayer plants the seed or plant. In the case of a taxpayer that acquires plants that have already been permanently planted, or plants that are tended by the taxpayer or another prior to permanent planting, the actual preproductive period of the plant begins upon acquisition of the plant by the taxpayer. In the case of the crop or yield of a plant that will have more than one crop or yield, the actual preproductive period begins when the plant has become productive in marketable quantities and the crop or yield first appears, for example, in the form of a sprout, bloom, blossom, or bud.

(2) End of the preproductive period—(i) In general. In the case of a plant that will have more than one crop or yield, the actual preproductive period ends when the plant first becomes productive in marketable quantities. In the case of any other plant (including the crop or yield of a plant that will have more than one crop or yield), the actual preproductive period ends when the plant, crop, or yield is sold or otherwise disposed of. Field costs, such as irrigating, fertilizing, spraying and pruning, that are incurred after the harvest of a crop or yield but before the crop or yield is sold or otherwise disposed of are not required to be included in the preproductive period costs of the harvested crop or yield because they do not benefit and are unrelated to the harvested crop or yield.

(ii) Marketable quantities. A plant that will have more than one crop or yield becomes productive in marketable quantities once a crop or yield is produced in sufficient quantities to be harvested and marketed in the ordinary course of the taxpayer’s business. Factors that are relevant to determining whether a crop or yield is produced in sufficient quantities to be harvested and marketed in the ordinary course include: whether the crop or yield is
harvested that is more than de minimis, although it may be less than expected at the maximum bearing stage, based on a comparison of the quantities per acre harvested in the year in question to the quantities per acre expected to be harvested when the plant reaches full maturity; and whether the sales proceeds exceed the costs of harvest and make a reasonable contribution to an allocable share of farm expenses.

(d) Examples. The following examples illustrate the provisions of this paragraph (b)(2):

Example 1. (i) Farmer A, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer A acquires 1 year-old plants by purchasing them from an unrelated party, Corporation B, and plants them immediately. The nationwide weighted average preproductive period of the plant is 4 years. The particular plants grown by Farmer A do not begin to produce in marketable quantities until 3 years and 6 months after they are planted by Farmer A.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer A is required to capitalize the costs of producing the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(1) of this section, Farmer A must begin to capitalize the preproductive period costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer A must continue to capitalize preproductive period costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer A must capitalize the preproductive period costs of the plants for a period of 3 years and 6 months (that is, until the plants are 4 years and 6 months old), notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 1 year and 11 months after they are planted by Farmer A.

Example 2. (i) Farmer B, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. The nationwide weighted average preproductive period of the plant is 2 years and 5 months. Farmer B acquires 1 month-old plants by purchasing them from an unrelated party, Corporation B, and plants them immediately. The nationwide weighted average preproductive period of the plant is 4 years.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the costs of producing the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(1) of this section, Farmer B must begin to capitalize the preproductive period costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer B must continue to capitalize preproductive period costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 2 years and 6 months (the 7 months the plants are tended by Corporation B and the 1 year and 11 months after the plants are planted by Farmer B), that is, until the plants are 2 years and 7 months old, notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 2 years and 5 months.

Example 3. (i) Assume the same facts as in Example 2, except that Farmer B acquires the plants by purchasing them from Corporation B when the plants are 8 months old and that the plants are planted by Farmer B upon acquisition.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the costs of producing the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(1) of this section, Farmer B must begin to capitalize the preproductive period costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer B must continue to capitalize the preproductive period costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 1 year and 11 months.

Example 4. (i) Farmer C, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer C acquires 1 month-old plants from an unrelated party and plants them immediately. The nationwide weighted average preproductive period of the plant is 3 years and 6 months.

(ii) Since the plants are deemed to have a nationwide weighted average preproductive period in excess of 2 years, Farmer C is required to capitalize the costs of producing the plants, notwithstanding the fact that the particular plants grown by Farmer C become
productive in less than 2 years. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(I) of this section, Farmer C must begin to capitalize the preproductive period costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer C properly ceases capitalization of preproductive period costs when the plants become productive in marketable quantities (that is, 1 year and 10 months after they are planted, which is when they are 1 year and 11 months old).

Example 5. (i) Farmer D, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are not grown in commercial quantities in the United States. Farmer D acquires and plants the plants when they are 1 year old and estimates that they will become productive in marketable quantities 3 years after planting. Thus, at the time the plants are acquired and planted Farmer D reasonably estimates that the plants will have a preproductive period of 4 years. The actual plants grown by Farmer D do not begin to produce in marketable quantities until 3 years and 6 months after they are planted by Farmer D.

(ii) Since the plants have an estimated preproductive period in excess of 2 years, Farmer D is required to capitalize the costs of producing the plants. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(I) of this section, Farmer D must begin to capitalize the preproductive period costs when it acquires and plants the plants. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer D must continue to capitalize the preproductive period costs until the plants begin to produce in marketable quantities. Thus, Farmer D must capitalize the preproductive period costs of the plants for a period of 3 years and 6 months (that is, until the plants are 4 years and 6 months old), notwithstanding the fact that Farmer D estimated that the plants would become productive after 4 years.

Example 6. (i) Farmer E, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants from seed. The plants are not grown in commercial quantities in the United States. Farmer E acquires the seeds for the plants which are 2 years and 2 months after the seeds are planted, when they are 2 years and 11 months old). Farmer E must begin to capitalize the costs of producing the plants into consideration when making future estimates of the preproductive period of such plants.

(ii) Because Farmer E’s estimate of the preproductive period (which was 2 years or less) was reasonable at the time made based on the facts, Farmer E will not be required to capitalize the costs of producing the plants under section 263A, notwithstanding the fact that the actual preproductive period of the plants exceeded 2 years. See paragraph (b)(2)(i)(B) of this section. However, Farmer E must take the actual preproductive period of the plants into consideration when making future estimates of the preproductive period of such plants.

Example 7. (i) Farmer F, a calendar year taxpayer that does not qualify for the exception in paragraph (a)(2) of this section, grows trees that will have more than one crop. Farmer F acquires and plants the trees in April, Year 1. On October 1, Year 6, the trees become productive in marketable quantities.

(ii) The costs of producing the plant, including the preproductive period costs incurred by Farmer F on or before October 1, Year 6, are capitalized to the trees. Preproductive period costs incurred after October 1, Year 6, are capitalized to a crop when incurred during the preproductive period of the crop and deducted as a cost of maintaining the tree when incurred between the disposal of one crop and the appearance of the next crop. See paragraphs (b)(2)(i)(A), (b)(2)(i)(C)(I) and (b)(2)(i)(C)(2) of this section.

Example 8. (i) Farmer G, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, produces fig trees on 10 acres of land. The fig trees are grown in commercial quantities in the United States and have a nationwide weighted average preproductive period in excess of 2 years. Farmer G acquires and plants the fig trees in their permanent grove during Year 1. When the fig trees are mature, Farmer G expects to harvest 10x tons of figs per acre. At the end of Year 4, Farmer G harvests 5x tons of figs per acre that it sells for $100x. During Year 4, Farmer G incurs expenses related to the fig operation of: $50x to harvest the figs and transport them to market and other direct and indirect costs related to the fig operation in the amount of $1000x.

(ii) The costs of producing the plant, in- cluding the preproductive period costs in- curred by Farmer G on or before October 1, Year 6, are capitalized to the trees. Preproductive period costs incurred after October 1, Year 6, are capitalized to a crop when incurred during the preproductive period of the crop and deducted as a cost of maintaining the tree when incurred between the disposal of one crop and the appearance of the next crop. See paragraphs (b)(2)(i)(A), (b)(2)(i)(C)(I) and (b)(2)(i)(C)(2) of this section.
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(ii) Animal. An animal’s actual preproductive period is used to determine the period that the taxpayer must capitalize preproductive period costs with respect to a particular animal.

(A) Beginning of the preproductive period. The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation.

(B) End of the preproductive period. In the case of an animal that will be used in the trade or business of farming (for example, a dairy cow), the preproductive period generally ends when the animal is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention). However, in the case of an animal that will have more than one yield (for example, a breeding cow), the preproductive period ends when the animal produces (for example, gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of.

(C) Allocation of costs between animal and yields. In the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield using any reasonable method. Any depreciation allowance on the animal may be allocated entirely to the yield. Costs incurred after the beginning of the preproductive period of the second yield, but before the first yield is weaned from the animal must be allocated between the first and second yield using any reasonable method. However, a taxpayer may elect to allocate these costs entirely to the second yield. An allocation method used by a taxpayer is a method of accounting that must be used consistently and is subject to the rules of section 446 and the regulations thereunder.

(c) Inventory methods—(1) In general. Except as otherwise provided, the costs required to be allocated to any plant or animal under this section may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. See §1.471–6. Under the unit-livestock-price method, unit prices must include all costs required to be capitalized under section 263A. A taxpayer using the unit-livestock-price method may elect to use the cost allocation methods in §1.263A–1(f) or 1.263A–2(b) to allocate its direct and indirect costs to the property produced in the business of farming. In such a situation, section 471 costs are the costs taken into account by the taxpayer under the unit-livestock-price method using the taxpayer’s standard unit price as modified by this paragraph (c)(1). Tax shelters, as defined in paragraph (a)(2)(ii) of this section, that use the unit-livestock-price method for inventories must include in inventory the annual standard unit price for all animals that are acquired during the taxable year, regardless of whether the purchases are made during the last 6 months of the taxable year. Taxpayers required by section 447 to use an accrual method or prohibited by section 448(a)(3) from using the cash method that use the unit-livestock-price method must modify the annual standard price in order to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit-livestock-price method.

(2) Available for property used in a trade or business. The farm-price method or the unit-livestock-price method may be used by any taxpayer to allocate costs to any plant or animal under this section, regardless of whether the plant or animal is held or treated as inventory property by the taxpayer. Thus, for example, a taxpayer may use the unit-livestock-price method to account for the costs of raising livestock that will be used in the trade or business of farming (for example, a breeding animal or a dairy cow) even though the property in question is not inventory property.

(3) Exclusion of property to which section 263A does not apply. Notwithstanding a taxpayer’s use of the farm-price method with respect to farm property to which the provisions of section 263A apply, that taxpayer is not
required, solely by such use, to use the farm-price method with respect to farm property to which the provisions of section 263A do not apply. Thus, for example, assume Farmer A raises fruit trees that have a preproductive period in excess of 2 years and to which the provisions of section 263A, therefore, apply. Assume also that Farmer A raises cattle and is not required to use an accrual method by section 447 or prohibited from using the cash method by section 448(a)(3). Because Farmer A qualifies for the exception in paragraph (a)(2) of this section, Farmer A is not required to capitalize the costs of raising the cattle. Although Farmer A may use the farm-price method with respect to the fruit trees, Farmer A is not required to use the farm-price method with respect to the cattle. Instead, Farmer A’s accounting for the cattle is determined under other provisions of the Code and regulations.

(d) Election not to have section 263A apply—(1) Introduction. This paragraph (d) permits certain taxpayers to make an election not to have the rules of this section apply to any plant produced in a farming business conducted by the electing taxpayer. The election is a method of accounting under section 446, and once an election is made, it is revocable only with the consent of the Commissioner.

(2) Availability of the election. The election described in this paragraph (d) is available to any taxpayer that produces plants in a farming business, except that no election may be made by a corporation, partnership, or tax shelter required to use an accrual method under section 447 or prohibited from using the cash method by section 448(a)(3). Moreover, the election does not apply to the costs of planting, cultivation, maintenance, or development of a citrus or almond grove (or any part thereof) incurred prior to the close of the fourth taxable year beginning with the taxable year in which the trees were planted in the permanent grove (including costs incurred prior to the permanent planting). If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting.

(3) Time and manner of making the election—(i) Automatic election. A taxpayer makes the election under this paragraph (d) by not applying the rules of section 263A to determine the capitalized costs of plants produced in a farming business and by applying the special rules in paragraph (d)(4) of this section on its original return for the first taxable year in which the taxpayer is otherwise required to capitalize section 263A costs. Thus, in order to be treated as having made the election under this paragraph (d), it is necessary to report both income and expenses in accordance with the rules of this paragraph (d) (for example, it is necessary to use the alternative depreciation system as provided in paragraph (d)(4)(i) of this section). For example, a farmer who deducts costs that are otherwise required to be capitalized under section 263A but fails to use the alternative depreciation system under section 168(g)(2) for applicable property placed in service has not made an election under this paragraph (d) and is not in compliance with the provisions of section 263A. In the case of a partnership or S corporation, the election must be made by the partner, shareholder, or member.

(ii) Nonautomatic election. A taxpayer that does not make the election under this paragraph (d) as provided in paragraph (d)(3)(i) must obtain the consent of the Commissioner to make the election by filing a Form 3115, Application for Change in Method of Accounting, in accordance with §1.446-1(e)(3).

(4) Special rules. If the election under this paragraph (d) is made, the taxpayer is subject to the special rules in this paragraph (d)(4).

(i) Section 1245 treatment. The plant produced by the taxpayer is treated as section 1245 property and any gain resulting from any disposition of the plant is recaptured (that is, treated as ordinary income) to the extent of the total amount of the deductions that, but for the election, would have been required to be capitalized with respect to the plant. In calculating the amount of gain that is recaptured under this paragraph (d)(4)(i), a taxpayer may use
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the farm-price method or another simplified method permitted under these regulations in determining the deductions that otherwise would have been capitalized with respect to the plant.

(ii) Required use of alternative depreciation system. If the taxpayer or a related person makes an election under this paragraph (d), the alternative depreciation system (as defined in section 168(g)(2)) must be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect. The requirement to use the alternative depreciation system by reason of an election under this paragraph (d) will not prevent a taxpayer from making an election under section 179 to deduct certain depreciation expenses of certain depreciable business assets.

(iii) Related person—(A) In general. For purposes of this paragraph (d)(4), related person means—

(1) The taxpayer and members of the taxpayer’s family;

(2) Any corporation (including an S corporation) if 50 percent or more of the stock (in value) is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer’s family;

(3) A corporation and any other corporation that is a member of the same controlled group (within the meaning of section 1563(a)(1)); and

(4) Any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer’s family.

(B) Members of family. For purposes of this paragraph (d)(4)(ii), the terms “members of the taxpayer’s family” and “members of family” (for purposes of applying section 318(a)(1)), means the spouse of the taxpayer (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) and any of the taxpayer’s children (including legally adopted children) who have not reached the age of 18 as of the last day of the taxable year in question.

(5) Examples. The following examples illustrate the provisions of this paragraph (d):

Example 1. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows apple trees that have a preproductive period greater than 2 years. In addition, Farmer A grows and harvests wheat and other grains. Farmer A elects under this paragraph (d) not to have the rules of section 263A apply to the costs of growing the apple trees.

(ii) In accordance with paragraph (d)(4) of this section, Farmer A is required to use the alternative depreciation system described in section 168(g)(2) with respect to all property used predominantly in any farming business in which Farmer A engages (including the growing and harvesting of wheat) if such property is placed in service during a year for which the election is in effect. Thus, for example, all assets and equipment (including trees and any equipment used to grow and harvest wheat) placed in service during a year for which the election is in effect must be depreciated as provided in section 168(g)(2).

Example 2. Assume the same facts as in Example 1, except that Farmer A and members of Farmer A’s family (as defined in paragraph (d)(4)(ii)(B) of this section) also own 51 percent (in value) of the interests in Partnership P, which is engaged in the trade or business of growing and harvesting corn. Partnership P is a related person to Farmer A under the provisions of paragraph (d)(4)(ii)(B) of this section. Thus, the requirements to use the alternative depreciation system under section 168(g)(2) also apply to any property used predominantly in a trade or business of farming which Partnership P places in service during a year for which an election made by Farmer A is in effect.

(e) Exception for certain costs resulting from casualty losses—(1) In general. Section 263A does not require the capitalization of costs that are attributable to the replanting, cultivating, maintaining, and developing of any plants bearing an edible crop for human consumption (including, but not limited to, plants that constitute a grove, orchard, or vineyard) that were lost or damaged while owned by the taxpayer by reason of freezing temperatures, disease, drought, pests, or other casualty (replanting costs). Such replanting costs may be incurred with respect to property other than the property on which the damage or loss occurred to the extent the acreage of the property with respect to which the replanting costs are incurred is not in excess of the acreage of the property on which the damage or loss occurred. This paragraph (e) applies only to the replanting
of plants of the same type as those lost or damaged. This paragraph (e) applies to plants replanted on the property on which the damage or loss occurred or property of the same or lesser acreage in the United States irrespective of differences in density between the lost or damaged and replanted plants. Plants bearing crops for human consumption are those crops normally eaten or drunk by humans. Thus, for example, costs incurred with respect to replanting plants bearing jojoba beans do not qualify for the exception provided in this paragraph (e) because that crop is not normally eaten or drunk by humans.

(2) Ownership. Replanting costs described in paragraph (e)(1) of this section generally must be incurred by the taxpayer that owned the property at the time the plants were lost or damaged. Paragraph (e)(1) of this section will apply, however, to costs incurred by a person other than the taxpayer that owned the plants at the time of damage or loss if—

(i) The taxpayer that owned the plants at the time the damage or loss occurred owns an equity interest of more than 50 percent in such plants at all times during the taxable year in which the replanting costs are paid or incurred; and

(ii) Such other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivating, maintaining, or developing of such plants during the taxable year in which the replanting costs are paid or incurred. A person will be treated as materially participating for purposes of this provision if such person would otherwise meet the requirements with respect to material participation within the meaning of section 2032A(e)(6).

(3) Examples. The following examples illustrate the provisions of this paragraph (e):

Example 1. (i) Farmer A grows cherry trees that have a preproductive period in excess of 2 years and produce an annual crop. These cherries are normally eaten by humans. Farmer A grows the trees on a 100 acre parcel of land (parcel 1) and the groves of trees cover the entire acreage of parcel 1. Farmer A also owns a 150 acre parcel of land (parcel 2) that Farmer A holds for future use. Both parcels are in the United States. In 2000, the trees and the irrigation and drainage systems that service the trees are destroyed in a casualty (within the meaning of paragraph (e)(1) of this section). Farmer A installs new irrigation and drainage systems on parcel 1, purchases young trees (seedlings), and plants the seedlings on parcel 1.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized. In accordance with paragraph (e)(1) of this section, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A.

Example 2. (i) Assume the same facts as in Example 1 except that Farmer A decides to replant the seedlings on parcel 2 rather than on parcel 1. Accordingly, Farmer A installs the new irrigation and drainage systems on 100 acres of parcel 2 and plants seedlings on those 100 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized. Because the acreage of the related portion of parcel 2 does not exceed the acreage of the destroyed orchard on parcel 1, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A. See paragraph (e)(1) of this section.

Example 3. (i) Assume the same facts as in Example 1 except that Farmer A replants the seedlings on parcel 2 rather than on parcel 1, and Farmer A additionally decides to expand its operations by growing 125 rather than 100 acres of trees. Accordingly, Farmer A installs new irrigation and drainage systems on 125 acres of parcel 2 and plants seedlings on those 125 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized. The costs of planting, cultivating, developing, and maintaining 100 acres of the trees during their preproductive period are not required to be capitalized by section 263A. The costs of planting, cultivating, maintaining, and developing the additional 25 acres are, however, subject to capitalization under section 263A. See paragraph (e)(1) of this section.

(4) Special rule for citrus and almond groves—(i) In general. The exception in this paragraph (e) is available with respect to replanting costs of a citrus or almond grove incurred prior to the close of the fourth taxable year after replanting, notwithstanding the taxpayer’s election to have section 263A not apply (described in paragraph (d) of this section).

(ii) Example. The following example illustrates the provisions of this paragraph (e)(4):
Example. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows citrus trees that have a preproductive period of 5 years. Farmer A elects, under paragraph (d) of this section, not to have section 263A apply. This election, however, is unavailable with respect to the costs of producing a citrus grove incurred within the first 4 years beginning with the year the trees were planted. See paragraph (d)(2) of this section. In year 10, after the citrus grove has become productive in marketable quantities, the citrus grove is destroyed by a casualty within the meaning of paragraph (e)(1) of this section. In year 10, Farmer A acquires and plants young citrus trees in the same grove to replace those destroyed by the casualty.

(ii) Farmer A must capitalize the costs of producing the citrus grove incurred before the close of the fourth taxable year beginning with the year in which the trees were permanently planted. As a result of the election not to have section 263A apply, Farmer A may deduct the preproductive period costs incurred in the fifth year. In year 10, Farmer A must capitalize the acquisition cost of the young trees. However, the costs of planting, cultivating, developing, and maintaining the young trees that replace those destroyed by the casualty are exempted from capitalization under this paragraph (e).

(f) Effective date and change in method of accounting—(1) Effective date. In the case of property that is not inventory in the hands of the taxpayer, this section is applicable to costs incurred after August 21, 2000 in taxable years ending after August 21, 2000. In the case of inventory property, this section is applicable to taxable years beginning after August 21, 2000.

(2) Change in method of accounting. Any change in a taxpayer’s method of accounting necessary to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. For property that is not inventory in the hands of the taxpayer, a taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with the provisions of this section for the first taxable year beginning after August 21, 2000. A taxpayer changing its method of accounting under this paragraph (f)(2) must file a Form 3115, “Application for Change in Accounting Method,” in accordance with the automatic consent procedures in Rev. Proc. 99–49 (1999–2 I.R.B. 725) (see § 601.601(d)(2) of this chapter). However, the scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply, provided the taxpayer’s method of accounting for property produced in a farming business is not an issue under consideration within the meaning of section 3.09 of Rev. Proc. 99–49. If the taxpayer is under examination, before an appeals office, or before a federal court at the time that a copy of the Form 3115 is filed with the national office, the taxpayer must provide a duplicate copy of the Form 3115 to the examining agent, appeals officer, or counsel for the government, as appropriate, at the time the copy of the Form 3115 is filed. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent, appeals officer, or counsel for the government, as appropriate. Further, in the case of property that is not inventory in the hands of the taxpayer, a change under this paragraph (f)(2) is made on a cutoff basis as described in section 2.06 of Rev. Proc. 99–49 and without the audit protection provided in section 7 of Rev. Proc. 99–49. However, a taxpayer may receive such audit protection for non-inventory property by taking into account any section 481(a) adjustment that results from the change in method of accounting to comply with this section. A taxpayer that opts to determine a section 481(a) adjustment (and, thus, obtain audit protection) for non-inventory property must take into account only additional section 263A costs incurred after December 31, 1986, in taxable years ending after December 31, 1986. Any change in method of accounting that is not made for the taxpayer’s first taxable year ending or beginning after August 21, 2000, whichever is applicable, must be made in accord with the procedures in Rev. Proc. 97–27 (1997–1 C.B. 680) (see § 601.601(d)(2) of this chapter).

[76 FR 60644, Aug. 21, 2000, as amended by 65 FR 61092, Oct. 16, 2000]
§ 1.263A–5 Exception for qualified creative expenses incurred by certain free-lance authors, photographers, and artists. [Reserved]

§ 1.263A–6 Rules for foreign persons. [Reserved]

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

(a) Introduction—(1) Purpose. These regulations provide guidance to taxpayers changing their methods of accounting for costs subject to section 263A. The principal purpose of these regulations is to provide guidance regarding how taxpayers are to revalue property on hand at the beginning of the taxable year in which they change their method of accounting for costs subject to section 263A. Paragraph (c) of this section provides guidance regarding how items or costs included in beginning inventory in the year of change must be revalued. Paragraph (d) of this section provides guidance regarding how non-inventory property should be revalued in the year of change.

(2) Taxpayers that adopt a method of accounting under section 263A. Taxpayers may adopt a method of accounting for costs subject to section 263A in the first taxable year in which they engage in resale or production activities. For purposes of this section, the adoption of a method of accounting has the same meaning as provided in § 1.446–1(e)(1). Taxpayers are not subject to the provisions of these regulations to the extent they adopt, as opposed to change, a method of accounting.

(3) Taxpayers that change a method of accounting under section 263A. Taxpayers changing their method of accounting for costs subject to section 263A are subject to the revaluation and other provisions of this section. Taxpayers subject to these regulations include, but are not limited to—

(i) Resellers of personal property whose average annual gross receipts for the immediately preceding 3-year period (or lesser period if the taxpayer was not in existence for the three preceding taxable years) exceed $10,000,000 where the taxpayer was not subject to section 263A in the prior taxable year;

(ii) Resellers of real or personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A;

(iii) Producers of real or tangible personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A; and

(iv) Producers of real or tangible personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A.

(4) Effective date. The provisions of this section are effective for taxable years beginning on or after August 5, 1997. For taxable years beginning before August 5, 1997, the rules of § 1.263A–7T contained in the 26 CFR part 1 edition revised as of April 1, 1997, as modified by other administrative guidance, will apply.

(5) Definition of change in method of accounting. For purposes of this section, a change in method of accounting has the same meaning as provided in § 1.446–1(e)(2)(ii). Changes in method of accounting for costs subject to section 263A include changes to methods required or permitted by section 263A and the regulations thereunder. Changes in method of accounting may be described in the preceding sentence irrespective of whether the taxpayer’s previous method of accounting resulted in the capitalization of more (or fewer) costs than the costs required to be capitalized under section 263A and the regulations thereunder, and irrespective of whether the taxpayer’s previous method of accounting was a permissible method under the law in effect when the method was being used. However, changes in method of accounting for costs subject to section 263A do not include changes relating to factors other than those described therein. For example, a change in method of accounting for costs subject to section 263A does not include a change from one inventory identification method to another inventory identification method, such as a change from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method, or vice versa, or a change from one inventory valuation method to another inventory valuation method under section 471, such as a
change from valuing inventory at cost to valuing the inventory at cost or market, whichever is lower, or vice versa. In addition, a change in method of accounting for costs subject to section 263A does not include a change within the LIFO inventory method, such as a change from the double extension method to the link-chain method, or a change in the method used for determining the number of pools. Further, a change from the modified resale method set forth in Notice 89–67 (1989–1 C.B. 723), see §601.601(d)(2) of this chapter, to the simplified resale method set forth in §1.263A–3(d) is not a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is therefore not subject to the provisions of this section. However, a change from the simplified resale method set forth in §1.263A–3(d) is a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is subject to the provisions of this section.

(b) Rules applicable to a change in method of accounting—(1) General rules. All changes in method of accounting for costs subject to section 263A are subject to the rules and procedures provided by the Code, regulations, and administrative procedures applicable to such changes. The Internal Revenue Service has issued specific revenue procedures that govern certain accounting method changes for costs subject to section 263A. Where a specific revenue procedure is not applicable, changes in method of accounting for costs subject to section 263A are subject to the same rules and procedures that govern other accounting method changes. See Rev. Proc. 97–27, (1997–21 I.R.B. 10) and §601.601(d)(2) of this chapter.

(2) Special rules—(i) Ordering rules when multiple changes in method of accounting occur in the year of change—(A) In general. A change in method of accounting for costs subject to section 263A is generally deemed to occur (including the computation of the adjustment under section 481(a)) before any other change in method of accounting is deemed to occur for that same taxable year.

(B) Exceptions to the general ordering rule—(1) Change from the LIFO inventory method. In the case of a taxpayer that is discontinuing its use of the LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the LIFO method may be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(2) Change from the specific goods LIFO inventory method. In the case of a taxpayer that is changing from the specific goods LIFO inventory method to the dollar-value LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the specific goods LIFO inventory method may be made before the change in method of accounting under section 263A is made.

(3) Change in overall method of accounting. In the case of a taxpayer that is changing its overall method of accounting from the cash receipts and disbursements method to an accrual method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the taxpayer must change to an accrual method for capitalizable costs (see §1.263A–1(c)(2)(ii)) before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(4) Change in method of accounting for depreciation. In the case of a taxpayer that is changing its method of accounting for depreciation in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change in method of accounting for depreciation must be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.
purposes of the adjustment required by section 481(a). The taxpayer must take the net Section 481(a) adjustment into account over the section 481(a) adjustment period as determined under the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner’s consent to a change in accounting method (for example, see Rev. Proc. 2002–9 (2002–1 C.B. 327) and Rev. Proc. 97–27 (1997–1 C.B. 680) (also see §601.601(d)(2) of this chapter)). This paragraph applies to taxable years ending on or after June 16, 2004.

(iii) Base year—(A) Need for a new base year. Certain dollar-value LIFO taxpayers (whether using double extension or link-chain) must establish a new base year when they revalue their inventories under section 263A.

(1) Facts and circumstances revaluation method used. A dollar-value LIFO taxpayer that uses the facts and circumstances revaluation method is permitted, but not required, to establish a new base year.

(2) 3-year average method used—(i) Simplified method not used. A dollar-value LIFO taxpayer using the 3-year average method but not the simplified production method or the simplified resale method to revalue its inventory is required to establish a new base year.

(ii) Simplified method used. A dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.

(B) Computing a new base year. For purposes of determining future indexes, the year of change becomes the new base year (that is, the index at the beginning of the year of change generally must be 1.00) and all costs are restated in new base year costs for purposes of extending such costs in future years. However, when a new base year is established, costs associated with old layers retain their separate identity within the base year, with such layers being restated in terms of the new base year index. For example, for purposes of determining whether a particular layer has been invaded, each layer must retain its separate identity. Thus, if a decrement in an inventory pool occurs, layers accumulated in more recent years must be viewed as invaded first, in order of priority.

(c) Inventory—(1) Need for adjustments. When a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer generally must, in computing its taxable income for the year of change, take into account the adjustments required by section 481(a). The adjustments required by section 481(a) relate to revaluations of inventory property, whether the taxpayer produces the inventory or acquires it for resale. See paragraph (d) of this section in regard to the adjustments required by section 481(a) that relate to non-inventory property.

(2) Revaluing beginning inventory—(1) In general. If a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer must revalue the items or costs included in its beginning inventory in the year of change as if the new method (that is, the method to which the taxpayer is changing) had been in effect during all prior years. In revaluing inventory costs under this procedure, all of the capitalization provisions of section 263A and the regulations thereunder apply to all inventory costs accumulated in prior years. The necessity to revalue beginning inventory as if these capitalization rules had been in effect for all prior years includes, for example, the revaluation of costs or layers incurred in taxable years preceding the transition period to the full absorption method of inventory costing as described in §1.471–11(e), regardless of whether a taxpayer employed a cut-off method under those regulations. The difference between the inventory as originally valued using the former method (that is, the method from which the taxpayer is changing) and the inventory as revalued using the new method is equal to the amount of the adjustment required under section 481(a).

(ii) Methods to revalue inventory. There are three methods available to revalue inventory. The first method, the facts and circumstances revaluation method, may be used by all taxpayers. Under this method, a taxpayer determines the direct and indirect costs that must be assigned to each item of inventory based on all the facts.
and circumstances. This method is described in paragraph (c)(2)(iii) of this section. The second method, the weighted average method, is available only in certain situations to taxpayers using the FIFO inventory method or the specific goods LIFO inventory method. This method is described in paragraph (c)(2)(iv) of this section. The third method, the 3-year average method, is available to all taxpayers using the dollar-value LIFO inventory method of accounting. This method is described in paragraph (c)(2)(v) of this section. The weighted average method and the 3-year average method revalue inventory through processes of estimation and extrapolation, rather than based on the facts and circumstances of a particular year’s data. All three methods are available regardless of whether the taxpayer elects to use a simplified method to capitalize costs under section 263A.

(iii) Facts and circumstances revaluation method—(A) In general. Under the facts and circumstances revaluation method, a taxpayer generally is required to revalue inventories by applying the capitalization rules of section 263A and the regulations thereunder to the production and resale activities of the taxpayer, with the same degree of specificity as required of inventory manufacturers under the law immediately prior to the effective date of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 1986–3 C.B. (Vol. 1)). Thus, for example, with respect to any prior year that is relevant in determining the total amount of the revalued balance as of the beginning of the year of change, the taxpayer must analyze the production and resale data for that particular year and apply the rules and principles of section 263A and the regulations thereunder to determine the appropriate revalued inventory costs. However, under the facts and circumstances revaluation method, a taxpayer may utilize reasonable estimates and procedures in valuing inventory costs if—

(1) The taxpayer lacks, and is not able to reconstruct from its books and records, actual financial and accounting data which is required to apply the capitalization rules of section 263A and the regulations thereunder to the relevant facts and circumstances surrounding a particular item of inventory or cost; and

(2) The total amounts of costs for which reasonable estimates and procedures are employed are not significant in comparison to the total restated value (including costs previously capitalized under the taxpayer’s former method) of the items or costs for the period in question.

(B) Exception. A taxpayer that is not able to comply with the requirement of paragraph (c)(2)(iii)(A)(2) of this section because of the existence of a significant amount of costs that would require the use of estimates and procedures must revalue its inventories under the procedures provided in paragraph (c)(2)(iv) or (v) of this section.

(C) Estimates and procedures allowed. The estimates and procedures of this paragraph (c)(2)(iii) include—

(1) The use of available information from more recent years to estimate the amount and nature of inventory costs applicable to earlier years; and

(2) The use of available information with respect to comparable items of inventory produced or acquired during the same year in order to estimate the costs associated with other items of inventory.

(D) Use by dollar-value LIFO taxpayers. Generally, a dollar-value LIFO taxpayer must recompute its LIFO inventory for each taxable year that the LIFO inventory method was used.

(E) Examples. The provisions of this paragraph (c)(2)(iii) are illustrated by the following three examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in all three examples is 1997. The examples read as follows:

Example 1. Taxpayer X lacks information for the years 1993 and earlier, regarding the amount of costs incurred in transporting finished goods from X’s factory to X’s warehouse and in storing those goods at the warehouse until their sale to customers. X determines that, for 1994 and subsequent years, these transportation and storage costs constitute 4 percent of the total costs of comparable goods under X’s method of accounting for such years. Under this paragraph (c)(2)(iii), X may assume that transportation
and storage costs for the years 1993 and earlier constitute 4 percent of the total costs of such goods.

Example 2. Assume the same facts as in Example 1, except that for the year 1993 and earlier, X used a different method of accounting for inventory costs whereunder significantly fewer costs were capitalized than amounts capitalized in later years. Thus, the application of transportation and storage based on a percentage of costs for 1994 and later years would not constitute a reasonable estimate for use in earlier years. X may use the information from 1994 and later years, if appropriate adjustments are made to reflect the differences in inventory costs for the applicable years, including, for example—

(i) Increasing the percentage of costs that are intended to represent transportation and storage costs to reflect the aggregate differences in capitalized amounts under the two methods of accounting; or

(ii) Taking the absolute dollar amount of transportation and storage costs for comparable goods in inventory and applying that amount (adjusted for changes in general price levels, where appropriate) to goods associated with 1993 and prior periods.

Example 3. Taxpayer Z lacks information for certain years with respect to factory administrative costs, subject to capitalization under section 263A and the regulations thereunder, incurred in the production of inventory in factory A. Z does have sufficient information to determine factory administrative costs with respect to production of inventory in factory B, wherein inventory items were produced during the same years as factory A. Z may use the information from factory B to determine the appropriate amount of factory administrative costs to capitalize as inventory costs for comparable items produced in factory A during the same years.

(iv) Weighted average method—(A) In general. A taxpayer using the FIFO method or the specific goods LIFO method of accounting for inventories may use the weighted average method as provided in this paragraph (c)(2)(iv) to estimate the change in the amount of costs that must be allocated to inventories for prior years. The weighted average method under this paragraph (c)(2)(iv) is only available to a taxpayer that lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method provided for in paragraph (c)(2)(iii) of this section. Moreover, a taxpayer that qualifies for the use of the weighted average method under this paragraph (c)(2)(iv) must utilize such method only with respect to items or costs for which it lacks sufficient information to revalue under the facts and circumstances revaluation method. Particular items or costs must be revalued under the facts and circumstances revaluation method if sufficient information exists to make such a revaluation.

If a taxpayer lacks sufficient information to otherwise apply the weighted average method under this paragraph (c)(2)(iv) (for example, the taxpayer is unable to revalue the costs of any of its items in inventory due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method, to whatever extent is necessary to allow the taxpayer to apply the weighted average method. (B) Weighted average method for FIFO taxpayers—(1) In general. This paragraph (c)(2)(iv)(B) sets forth the mechanics of the weighted average method as applicable to FIFO taxpayers. Under the weighted average method, an item in ending inventory for which sufficient data is not available for revaluation under section 263A and the regulations thereunder must be revalued by using the weighted average percentage increase or decrease with respect to such item for the earliest subsequent taxable year for which sufficient data is available. With respect to an item for which no subsequent data exists, such item must be revalued by using the weighted average percentage increase or decrease with respect to all reasonably comparable items in the taxpayer’s inventory for the same year or the earliest subsequent taxable year for which sufficient data is available.

(2) Example. The provisions of this paragraph (c)(2)(iv)(B) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. Taxpayer A manufactures bolts and uses the FIFO method to identify inventories. Under A’s former method, A did not capitalize all of the costs required to be capitalized under section 263A. A maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1994. The revaluation of the costs of Bolt A under this section for bolts produced in 1994

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results in a 20 percent increase of the costs of Bolt A. A portion of the inventory of Bolt A, however, is attributable to 1993. A does not have sufficient data for revaluation of the 1993 cost for Bolt A. With respect to Bolt A, A may apply the 20 percent increase determined for 1994 to the 1993 production as an acceptable estimate. Bolt B was last produced in 1992 and no data exists that would allow revaluation of the inventory cost of Bolt B. The inventories of all other bolts for which information is available are attributable to 1994 and 1995. Revaluation of the costs of these other bolts using available data results in an average increase in inventory costs of 15 percent for 1994 production. With respect to Bolt B, the overall 15 percent increase for A’s inventory for 1994 may be used in revaluing the cost of Bolt B.

(C) Weighted average method for specific goods LIFO taxpayers—(1) In general. This paragraph (c)(2)(iv)(C) sets forth the mechanics of the weighted average method as applicable to LIFO taxpayers using the specific goods method of valuing inventories. Under the weighted average method, the inventory layers with respect to an item for which data is available are revalued under this section and the increase or decrease in amount for each layer is expressed as a percentage of change from the cost in the layer as originally valued. A weighted average of the percentage of change for all layers for each type of good is computed and applied to all earlier layers for each type of good that lack sufficient data to allow for revaluation. In the case of earlier layers for which sufficient data exists, such layers are to be revalued using actual data. In cases where sufficient data is not available to make a weighted average estimate with respect to a particular item of inventory, a weighted average increase or decrease is to be determined using all other inventory items revalued by the taxpayer in the same specific goods grouping. This percentage increase or decrease is then used to revalue the cost of the item for which data is lacking. If the taxpayer lacks sufficient data to revalue any of the inventory items contained in a specific goods grouping, then the weighted average increase or decrease of substantially similar items (as determined by principles similar to the rules applicable to dollar-value LIFO taxpayers in §1.472–8(b)(3)) must be applied in the revaluation of the items in such grouping. If insufficient data exists with respect to all the items in a specific goods grouping and to all items that are substantially similar (or such items do not exist), then the weighted average for all revalued items in the taxpayer’s inventory must be applied in revaluing items for which data is lacking.

(2) Example. The provisions of this paragraph (c)(2)(iv)(C) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (1) Taxpayer M is a manufacturer that produces two different parts. Under M’s former method, M did not capitalize all of the costs required to be capitalized under section 263A. Work-in-process inventory is recorded in terms of equivalent units of finished goods. M’s records show the following at the end of 1996 under the specific goods LIFO inventory method:

<table>
<thead>
<tr>
<th>LIFO Product and layer</th>
<th>Number</th>
<th>Cost</th>
<th>Carrying values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product #1:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product #2:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
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<td></td>
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<td>1995</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total carrying value of Products #1 and #2 under M’s former method</td>
<td>500</td>
<td></td>
<td>$5,150</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number</th>
<th>Cost</th>
<th>Carrying values</th>
</tr>
</thead>
<tbody>
<tr>
<td>150</td>
<td>$5.00</td>
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<td>200</td>
<td>4.50</td>
<td>900</td>
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<tr>
<td>100</td>
<td>5.00</td>
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</tr>
<tr>
<td>100</td>
<td>6.00</td>
<td>600</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2,800</td>
</tr>
</tbody>
</table>

VerDate Mar<15>2010 11:25 May 22, 2012 Jkt 226088 PO 00000 Frm 00704 Fmt 8010 Sfmt 8010 Y:\SGML\226088.XXX 226088erowe on DSK2VPTVN1PROD with CFR
(ii) M has sufficient data to revalue the unit costs of Product #1 using its new method for 1994, 1995 and 1996. These costs are: $7.00 in 1994, $7.75 in 1995, and $9.00 in 1996. This data for Product #1 results in a weighted average percentage change of 20.31 percent ((100×($7.00−$6.00))+(100×($7.75−$6.50))+(50×($9.00−$7.00))) divided by (100×$6.00)+(100×$6.50)+(50×$7.00)). M has sufficient data to revalue the unit costs of Product #2 only in 1995 and 1996. These costs are: $6.00 in 1995 and $7.00 in 1996. This data for Product #2 results in a weighted average percentage change of 18.18 percent ((100×($6.00−$5.00))+(100×($7.00−$6.00))) divided by (100×$5.00)+(100×$6.00)).

<table>
<thead>
<tr>
<th>LIFO product and layer</th>
<th>Number</th>
<th>Cost</th>
<th>Carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product #1:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>150</td>
<td>$6.02</td>
<td>$903</td>
</tr>
<tr>
<td>1994</td>
<td>100</td>
<td>7.00</td>
<td>700</td>
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<td>1995</td>
<td>100</td>
<td>7.75</td>
<td>775</td>
</tr>
<tr>
<td>1996</td>
<td>50</td>
<td>9.00</td>
<td>450</td>
</tr>
<tr>
<td>Product #2:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>200</td>
<td>4.73</td>
<td>846</td>
</tr>
<tr>
<td>1994</td>
<td>200</td>
<td>5.32</td>
<td>1,064</td>
</tr>
<tr>
<td>1995</td>
<td>100</td>
<td>6.00</td>
<td>600</td>
</tr>
<tr>
<td>1996</td>
<td>100</td>
<td>7.00</td>
<td>700</td>
</tr>
<tr>
<td>Total value of Products #1 and #2 as revalued under M's new method</td>
<td></td>
<td></td>
<td>3,310</td>
</tr>
<tr>
<td>Total amount of adjustment required under section 481(a)</td>
<td></td>
<td></td>
<td>6,138</td>
</tr>
<tr>
<td>($6,138 − $5,150)</td>
<td></td>
<td></td>
<td>988</td>
</tr>
</tbody>
</table>

(D) Adjustments to inventory costs from prior years. For special rules applicable when a revaluation using the weighted average method includes costs not incurred in prior years, see paragraph (c)(2)(v)(E) of this section.

(v) 3-year average method—(A) In general. A taxpayer using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on the 3-year average method as provided in this paragraph (c)(2)(v). The 3-year average method is based on the average percentage change (the 3-year revaluation factor) in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer has sufficient information (typically, the three most recent taxable years of such trade or business). The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. The 3-year average method is available to any dollar-value taxpayer that complies with the requirements of this paragraph (c)(2)(v) regardless of whether such taxpayer lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method prescribed in paragraph (c)(2)(iii) of this section. The 3-year average method must be applied with respect to all inventory in a taxpayer’s trade or business. A taxpayer is not permitted to apply the method for the revaluation of some, but not all, inventory amounts that do not constitute a separate trade or business. Generally, a taxpayer revaluing its inventory using the 3-year average method must establish a new base year. See, paragraph (b)(2)(iii)(A)/(2)(i) of this section. However, a dollar-value LIFO taxpayer using the 3-year average method
and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year. See, paragraph (b)(2)(ii) of this section. If a taxpayer lacks sufficient information to otherwise apply the 3-year average method under this paragraph (c)(2)(v) (for example, the taxpayer is unable to revalue the costs of any of its LIFO pools for three years due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (c)(2)(i) of this section, to whatever extent is necessary to allow the taxpayer to apply the 3-year average method.

(B) Consecutive year requirement. Under the 3-year average method, if sufficient data is available to calculate the revaluation factor for more than three years, the taxpayer may use data from such additional years in determining the average percentage increase or decrease only if the additional years are consecutive to and prior to the year of change. The requirement under the preceding sentence to use consecutive years is applicable under this method regardless of whether any inventory costs in beginning inventory as of the year of change are viewed as incurred in, or attributable to, those consecutive years under the LIFO inventory method. Thus, the requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred. For example, if a taxpayer is changing its method of accounting in 1997 and has sufficient data to revalue its inventory for the years 1991 through 1996, the taxpayer may calculate the revaluation factor using all six years. If, however, the taxpayer has sufficient data to revalue its inventory for the years 1990 through 1992, and 1994 through 1996, only the three years consecutive to the year of change, that is, 1994 through 1996, may be used in determining the revaluation factor. Similarly, for example, a taxpayer with LIFO increments in 1995, 1993, and 1992 may not calculate the revaluation factor based on the data from those years alone, but instead must use the data from consecutive years for which the taxpayer has information.

(C) Example. The provisions of this paragraph (c)(2)(v) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Taxpayer G, a calendar year taxpayer, is a reseller that is required to change its method of accounting under section 263A. G will not use either the simplified production method or the simplified resale method. G adopted the dollar-value LIFO inventory method in 1991, using a single pool and the double extension method. G's beginning LIFO inventory as of January 1, 1997, computed using its former method, for the year of change is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Base Layer</th>
<th>Index</th>
<th>LIFO Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$14,000</td>
<td>1.00</td>
<td>$14,000</td>
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<tr>
<td>1991</td>
<td>4,000</td>
<td>1.20</td>
<td>4,800</td>
</tr>
<tr>
<td>1992</td>
<td>5,000</td>
<td>1.30</td>
<td>6,500</td>
</tr>
<tr>
<td>1993</td>
<td>2,000</td>
<td>1.35</td>
<td>2,700</td>
</tr>
<tr>
<td>1994</td>
<td>0</td>
<td>1.40</td>
<td>0</td>
</tr>
<tr>
<td>1995</td>
<td>4,000</td>
<td>1.50</td>
<td>6,000</td>
</tr>
<tr>
<td>1996</td>
<td>5,000</td>
<td>1.60</td>
<td>8,000</td>
</tr>
<tr>
<td>Total</td>
<td>34,000</td>
<td></td>
<td>42,000</td>
</tr>
</tbody>
</table>

(ii) G is able to recompute total inventoriable costs incurred under its new method for the three preceding taxable years as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Cost as Recorded (Former Method)</th>
<th>Current Cost as Adjusted (New Method)</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>$35,000</td>
<td>$45,150</td>
<td>.29</td>
</tr>
</tbody>
</table>
(iii) Applying the average revaluation factor of .28 to each layer, G’s inventory is restated as follows:

<table>
<thead>
<tr>
<th>Layer</th>
<th>Restated base year costs</th>
<th>Index</th>
<th>Restated LIFO carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base layer</td>
<td>$17,920</td>
<td>1.00</td>
<td>$17,920</td>
</tr>
<tr>
<td>1991 layer</td>
<td>8,320</td>
<td>1.20</td>
<td>6,144</td>
</tr>
<tr>
<td>1992 layer</td>
<td>6,400</td>
<td>1.30</td>
<td>8,320</td>
</tr>
<tr>
<td>1993 layer</td>
<td>2,560</td>
<td>1.35</td>
<td>3,456</td>
</tr>
<tr>
<td>1994 layer</td>
<td>0</td>
<td>1.40</td>
<td>0</td>
</tr>
<tr>
<td>1995 layer</td>
<td>5,120</td>
<td>1.50</td>
<td>7,680</td>
</tr>
<tr>
<td>1996 layer</td>
<td>6,400</td>
<td>1.60</td>
<td>10,240</td>
</tr>
<tr>
<td>Total</td>
<td>43,520</td>
<td></td>
<td>53,760</td>
</tr>
</tbody>
</table>

(iv) The adjustment required by section 481(a) is $11,760. This amount may be computed by multiplying the average percentage of .28 by the LIFO carrying value of G’s inventory valued using its former method ($42,000). Alternatively, the adjustment required by section 481(a) may be computed by the difference between—

(A) The revalued costs of the taxpayer’s inventory under its new method ($53,760), and
(B) The costs of the taxpayer’s inventory using its former method ($42,000).

(v) In addition, the inventory as of the first day of the year of change (January 1, 1997) becomes the new base year cost for purposes of determining the LIFO index in future years. See, paragraphs (b)(2)(iii)(A)(2)(i) and (b)(2)(ii)(B) of this section. This requires that layers in years prior to the base year be restated in terms of the new base year index. The current year cost of G’s inventory, as adjusted, is $70,720. Such cost must be apportioned to each layer in proportion to the restated base year cost of that layer to total restated base year costs ($43,520), as follows:

<table>
<thead>
<tr>
<th>Layer</th>
<th>Restated base year costs</th>
<th>Restated index</th>
<th>Restated LIFO carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Old base layer</td>
<td>$29,120</td>
<td>.615</td>
<td>$17,920</td>
</tr>
<tr>
<td>1991 layer</td>
<td>8,320</td>
<td>.738</td>
<td>6,144</td>
</tr>
<tr>
<td>1992 layer</td>
<td>10,400</td>
<td>.80</td>
<td>8,320</td>
</tr>
<tr>
<td>1993 layer</td>
<td>4,160</td>
<td>.831</td>
<td>3,456</td>
</tr>
<tr>
<td>1994 layer</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1995 layer</td>
<td>8,320</td>
<td>.923</td>
<td>7,680</td>
</tr>
<tr>
<td>1996 layer</td>
<td>10,400</td>
<td>.985</td>
<td>10,240</td>
</tr>
<tr>
<td>Total</td>
<td>70,720</td>
<td></td>
<td>53,760</td>
</tr>
</tbody>
</table>

(D) Short taxable years. A short taxable year is treated as a full 12 months.

(E) Adjustments to inventory costs from prior years—(1) General rule. (i) The use of the revaluation factor, based on current costs, to estimate the revaluation of prior inventory layers under the 3-year average method, as described in paragraph (c)(2)(v) of this section, may result in an allocation of costs that include amounts attributable to costs not incurred during the year in which the layer arose. To the extent a taxpayer can demonstrate that costs that contributed to the determination of the revaluation factor could not have affected a prior year, the revaluation factor as applied to that year may be adjusted under the restatement adjustment procedure, as described in paragraph (c)(2)(i)(F) of this section. The determination that a cost could not...
¶ 1.263A-7

have affected a prior year must be made by a taxpayer only upon showing that the type of cost incurred during the years used to calculate the revaluation factor (revaluation years) was not present during such prior year. An item of cost will not be eligible for the restatement adjustment procedure simply because the cost varies in amount from year to year or the same type of cost is described or referred to by a different name from year to year. Thus, the restatement adjustment procedure allowed under paragraph (c)(2)(v)(E) of this section is not available in a prior year with respect to a particular cost if the same type of cost was incurred both in the revaluation years and in such prior year, although the amount of such cost and the name or description thereof may vary.

(ii) The provisions of this paragraph (c)(2)(v)(E) are also applicable to taxpayers using the weighted average method in valuing inventories under paragraph (c)(2)(iv) of this section. Thus, to the extent a taxpayer can demonstrate that costs that contributed to the determination of the revaluation factor to such prior tax year could not have affected a prior year or item, the taxpayer may adjust the revaluation of that prior year or item accordingly under the weighted average method. All the requirements and definitions, however, applicable to the restatement adjustment procedure under this paragraph (c)(2)(v)(E) fully apply to a taxpayer using the weighted average method to revalue inventories.

(2) Examples of costs eligible for restatement adjustment procedure. The provisions of this paragraph (c)(2)(v)(E) are illustrated by the following four examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the four examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that introduced a defined benefit pension plan in 1994, and made the plan available to personnel whose labor costs were (directly or indirectly) properly allocable to resale activities. Based on these facts, the costs of the pension plan in the revaluation years are eligible for the restatement adjustment procedure for years prior to 1994.

Example 2. Assume the same facts as in Example 1, except that a defined contribution plan was available, during prior years, to personnel whose labor costs were properly allocable to resale activities. The defined contribution plan was terminated before the introduction of the defined benefit plan in 1994. Based on these facts, the costs of the defined benefit pension plan in the revaluation years are not eligible for the restatement adjustment procedure with respect to years for which the defined contribution plan existed.

Example 3. Taxpayer C is a manufacturer that established a security department in 1995 to patrol and safeguard its production and warehouse areas used in C's trade or business. Prior to 1995, C had not been required to utilize security personnel in its trade or business; C established the security department in 1995 in response to increasing vandalism and theft at its plant locations. Based on these facts, the costs of the security department are eligible for the restatement adjustment procedure for years prior to 1995.

Example 4. Taxpayer D is a reseller that established a payroll department in 1995 to process the company's weekly payroll. In the years 1991 through 1994, D engaged the services of an outside vendor to process the company's payroll. Prior to 1991, D's payroll processing was done by D's accounting department, which was responsible for payroll processing as well as for other accounting functions. Based on these facts, the costs of the payroll department are not eligible for the restatement adjustment procedure. D was incurring the same type of costs in earlier years as D was incurring in the payroll department in 1995 and subsequent years, although these costs were designated by a different name or description.

(F) Restatement adjustment procedure—(i) In general. (ii) This paragraph (c)(2)(v)(F) provides a restatement adjustment procedure whereunder a taxpayer may adjust the restatement of inventory costs in prior taxable years in order to produce a different restated value than the value that would otherwise occur through application of the revaluation factor to such prior taxable years.

(ii) Under the restatement adjustment procedure as applied to a particular prior year, a taxpayer must determine the particular items of cost that are eligible for the restatement adjustment with respect to such prior year. The taxpayer must then recompute, using reasonable estimates and procedures, the total inventoriable
costs that would have been incurred for each revaluation year under the taxpayer’s former method and the taxpayer’s new method by making appropriate adjustments in the data for such revaluation year to reflect the particular costs eligible for adjustment.

(iii) The taxpayer must then compute the total percentage change with respect to each revaluation year, using the revised estimates of total inventoriable costs for such year as described in paragraph (c)(2)(v)(F)(i) of this section. The percentage change must be determined by calculating the ratio of the revised total of the inventoriable costs for such revaluation year under the taxpayer’s new method to the revised total of the inventoriable costs for such revaluation year under the taxpayer’s former method.

(iv) An average of the resulting percentage change for all revaluation years is then calculated, and the resulting average is applied to the prior year in issue.

(2) Examples of restatement adjustment procedure. The provisions of this paragraph (c)(2)(v)(F) are illustrated by the following two examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the two examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that is eligible to make a restatement adjustment by reason of the costs of a defined benefit pension plan that was introduced in 1994, during the revaluation period. The revaluation factor, before adjustment of data to reflect the pension costs, is as provided in the example in paragraph (c)(2)(v)(C) of this section. Thus, for example, with respect to the year 1994, the total inventoriable costs under A’s former method is $35,000, the total inventoriable costs under A’s new method is $35,150, and the percentage change is .29. Under the method of accounting used by A during 1994 (the former method), none of the pension costs were included as inventoriable costs. Thus, under the restatement adjustment procedure, the total inventoriable cost under A’s former method would remain at $35,000 if the pension plan had not been in existence. Similarly, A determines that the total inventoriable costs for 1994 under A’s former method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .20 (($42,000–$35,000)/$35,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence. Such revalued layers would then be viewed as restated in compliance with the requirements of this paragraph. With respect to cost layers incurred during years for which the pension plan was in existence, no adjustment of the revaluation factor would occur.

Example 2. Assume the same facts as in Example 1, except that a portion of the pension costs were included as inventoriable costs under the method used by A during 1994 (the former method). Under the restatement adjustment procedure, A determines that the total inventoriable costs for 1994 under the former method, if the pension plan had not been in existence, would have been $34,000. Similarly, A determines that the total inventoriable costs for 1994 under A’s new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .24 (($42,000–$34,000)/$34,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence.

(3) Intercompany items—(1) Revaluing intercompany transactions. Pursuant to any change in method of accounting for costs subject to section 263A, taxpayers are required to revalue the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted, had the cost of goods sold for that inventory property been determined under the taxpayer’s new method. The requirement of the preceding sentence applies with respect to both inventory property produced by a taxpayer and inventory acquired by the taxpayer for resale. In addition, the requirements of this paragraph (c)(3) apply only to any intercompany item of the taxpayer as of the beginning of the year of change in method of accounting. See §1.1502-13(b)(2)(ii). A taxpayer must revalue the amount of any intercompany item
only if the inventory property sold in the intercompany transaction is held as inventory by a buying member as of the date the taxpayer changes its method of accounting under section 263A. Corresponding changes to the adjustment required under section 481(a) must be made with respect to any adjustment of the intercompany item required under this paragraph (c)(3). Moreover, the requirements of this paragraph (c)(3) apply regardless of whether the taxpayer has any items in beginning inventory as of the year of change in method of accounting. See §1.1502–13 for the definition of intercompany transaction.

(ii) Example. The provisions of this paragraph (c)(3) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Assume that S, a member of a consolidated group filing its federal income tax return on a calendar year, manufactures and sells inventory property to B, a member of the same consolidated group, in 1996. The sale between S and B is an intercompany transaction as defined under §1.1502–13(b)(1). The gain from the intercompany transaction is an intercompany item to S under §1.1502–13(b)(2). As of the beginning of the year of change in method of accounting (January 1, 1997), the inventory property is still held by B based on the particular inventory method of accounting used by B for federal income tax purposes (for example, the LIFO or FIFO inventory method). The property was sold by S to B in 1996 for $150; the cost of goods sold with respect to the property under the method in effect at the time the inventory was produced was $100, resulting in an intercompany item of $50 to S under §1.1502–13. As of January 1, 1997, S still has an intercompany item of $50.

(ii) S is required to revalue the amount of its intercompany item to an amount equal to the cost of goods sold for that inventory property that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer’s new method, a taxpayer may use the other methods and procedures otherwise available to that particular taxpayer in valuing the amount of its intercompany item resulting from the intercompany transaction. Moreover, S is required to increase its adjustment under section 481(a) by $10 in order to prevent the omission of such amount by virtue of the decrease in the intercompany item.

(iii) Availability of revaluation methods. In revaluing the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer’s new method, a taxpayer may use the other methods and procedures otherwise properly available to that particular taxpayer in valuing the inventory property under section 263A and the regulations thereunder, including, if appropriate, the various simplified methods provided in section 263A and the regulations thereunder and the various procedures described in this paragraph (c).

(4) Anti-abuse rule—(i) In general. Section 263A(i)(1) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of section 263A and the regulations thereunder. One way in which the application of section 263A and the regulations thereunder would be otherwise avoided is through the use of entities described in the preceding sentence in such a manner as to effectively avoid the necessity to restate beginning inventory balances under the change in method of accounting required or permitted under section 263A and the regulations thereunder.

(ii) Deemed avoidance of this section—(A) Scope. For purposes of this paragraph (c), the avoidance of the application of section 263A and the regulations thereunder will be deemed to occur if a taxpayer using the LIFO method of accounting for inventories, transfers inventory property to a related corporation in a transaction described in section 351, and such transfer occurs:

(1) On or before the beginning of the transferor’s taxable year beginning in 1987; and

(2) After September 18, 1986.

(B) General rule. Any transaction described in paragraph (c)(4)(ii)(A) of this paragraph (c) is deemed to be a transaction described in paragraph (c)(4)(ii)(A) of this paragraph (c) for purposes of this paragraph (c).
section will be treated in the following manner:

(1) Notwithstanding any provision to the contrary (for example, section 381), the transferee corporation is required to revalue the inventories acquired from the transferor under the provisions of this paragraph (c) relating to the change in method of accounting and the adjustment required by section 481(a), as if the inventories had never been transferred and were still in the hands of the transferor; and

(2) Absent an election as described in paragraph (c)(4)(iii) of this section, the transferee must account for the inventories acquired from the transferor by treating such inventories as if they were contained in the transferee’s LIFO layer(s).

(iii) Election to use transferor’s LIFO layers. If a transferee described in paragraph (c)(4)(ii) of this section so elects, the transferee may account for the inventories acquired from the transferor by allocating such inventories to LIFO layers corresponding to the layers to which such properties were properly allocated by the transferor, prior to their transfer. The transferee must account for such inventories for all subsequent periods with reference to such layers to which the LIFO costs were allocated. Any such election is to be made on a statement attached to the timely filed federal income tax return of the transferee for the first taxable year for which section 263A and the regulations thereunder applies to the transferee.

(iv) Tax avoidance intent not required. The provisions of paragraph (c)(4)(ii) of this section will apply to any transaction described therein, without regard to whether such transaction was consummated with an intention to avoid federal income taxes.

(v) Related corporation. For purposes of this paragraph (c)(4), a taxpayer is related to a corporation if—

(A) the relationship between such persons is described in section 267(b)(1), or

(B) such persons are engaged in trades or businesses under common control (within the meaning of paragraphs (a) and (b) of section 52).

(d) Non-inventory property—(1) Need for adjustments. A taxpayer that changes its method of accounting for costs subject to section 263A with respect to non-inventory property must revalue the non-inventory property on hand at the beginning of the year of change as set forth in paragraph (d)(2) of this section, and compute an adjustment under section 481(a). The adjustment under section 481(a) will equal the difference between the adjusted basis of the property as revalued using the taxpayer’s new method and the adjusted basis of the property as originally valued using the taxpayer’s former method.

(2) Revaluing property. A taxpayer must revalue its non-inventory property as of the beginning of the year of change in method of accounting. The facts and circumstances revaluation method of paragraph (c)(2)(iii) of this section must be used to revalue this property. In revaluing non-inventory property, however, the only additional section 263A costs that must be taken into account are those additional section 263A costs incurred after the later of December 31, 1986, or the date the taxpayer first becomes subject to section 263A, in taxable years ending after that date. See §1.263A–1(d)(3) for the definition of additional section 263A costs.

property that includes both components subject to an allowance for depreciation or depletion and components not subject to an allowance for depreciation or depletion is ratably allocated among, and is treated as a cost of, components that are subject to an allowance for depreciation or depletion.

(3) Methods of accounting under section 263A(f). Except as otherwise provided, methods of accounting and other computations under §§1.263A–8 through 1.263A–15 are applied on a taxpayer, as opposed to a separate and distinct trade or business, basis.

(4) Special definitions—(i) Related person. Except as otherwise provided, for purposes of §§1.263A–8 through 1.263A–15, a person is related to a taxpayer if their relationship is described in section 267(b) or 707(b).

(ii) Placed in service. For purposes of §§1.263A–8 through 1.263A–15, placed in service has the same meaning as set forth in §1.46–3(d).

(b) Designated property—(1) In general. Except as provided in paragraphs (b)(3) and (b)(4) of this section, designated property means any property that is produced and that is either:

(i) Real property; or

(ii) Tangible personal property (as defined in §1.263A–2(a)(2)) which meets any of the following criteria:

(A) Property with a class life of 20 years or more under section 168 (long-lived property), but only if the property is not property described in section 1221(l) in the hands of the taxpayer or a related person,

(B) Property with an estimated production period (as defined in §1.263A–12) exceeding 2 years (2-year property), or

(C) Property with an estimated production period exceeding 1 year and an estimated cost of production exceeding $1,000,000 (1-year property).

(2) Special rules—(i) Application of thresholds. The thresholds described in paragraphs (b)(1)(i)(A), (B), and (C) of this section are applied separately for each unit of property (as defined in §1.263A–10).

(ii) Relevant activities and costs. For purposes of determining whether property is designated property, all activities and costs are taken into account if they are performed or incurred by, or for, the taxpayer or any related persons and they directly benefit or are incurred by reason of the production of the property.

(iii) Production period and cost of production. For purposes of applying the classification thresholds under paragraphs (b)(1)(i)(B) and (C) of this section to a unit of property, the taxpayer is required, at the beginning of the production period, to reasonably estimate the production period and the total cost of production for the unit of property. The taxpayer must maintain contemporaneous written records supporting the estimates and classification. If the estimates are reasonable based on the facts in existence at the beginning of the production period, the taxpayer’s classification of the property is not modified in subsequent periods, even if the actual length of the production period or the actual cost of production differs from the estimates. To be considered reasonable, estimates of the production period and the total cost of production must include anticipated expense and time for delay, rework, change orders, and technological, design or other problems. To the extent that several distinct activities related to the production of the property are expected to occur simultaneously, the period during which these distinct activities occur is not counted more than once. The bases of assets used to produce a unit of property (within the meaning of §1.263A–11(d)) and any interest that would be required to be capitalized if a unit of property were designated property are disregarded in making estimates of the total cost of production for purposes of this paragraph (b)(2)(iii).

(3) Excluded property. Designated property does not include:

(i) Timber and evergreen trees that are more than 6 years old when severed from the roots, or

(ii) Property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit.

(4) De minimis rule—(i) In general. Designated property does not include property for which—

(A) The production period does not exceed 90 days; and
(B) The total production expenditures do not exceed $1,000,000 divided by the number of days in the production period.

(ii) Determination of total production expenditures. For purposes of determining whether the condition of paragraph (b)(4)(i)(B) of this section is met with respect to property, the cost of land, the adjusted basis of property used to produce property, and interest that would be capitalized with respect to property if it were designated property are excluded from total production expenditures.

(c) Definition of real property—(1) In general. Real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Any interest in real property of a type described in this paragraph (c), including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property under this section. Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Tenant improvements to a building that are inherently permanent or otherwise classified as real property within the meaning of this paragraph (c)(1) are real property under this section. However, property produced for sale that is not real property in the hands of the taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer (e.g., bricks, nails, paint, and windowpanes).

(2) Unsevered natural products of land. Unsevered natural products of land include growing crops and plants, mines, wells, and other natural deposits. Growing crops and plants, however, are real property only if the preproductive period of the crop or plant exceeds 2 years.

(3) Inherently permanent structures. Inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. For purposes of this section, affixation to real property may be accomplished by weight alone. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former section 48(a)(1)(B) and §1.48–1. Any property not otherwise described in this paragraph (c)(3) that constitutes other tangible property under the principles of former section 48(a)(1)(B) and §1.48–1(d) is treated for the purposes of this section as an inherently permanent structure.

(4) Machinery—(i) Treatment. A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is not real property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property.

(ii) Certain factors not determinative. A structure may be an inherently permanent structure, and not property in the nature of machinery, even if the structure is necessary to operate or use, supports, or is otherwise associated with machinery.

(d) Production—(1) Definition of produce. Produce is defined as provided in section 263A(g) and §1.263A–2(a)(1)(i).

(2) Property produced under a contract—(i) Customer. A taxpayer is treated as producing any property that is produced for the taxpayer (the customer) by another party (the contractor) under a contract with the taxpayer or an intermediary. Property produced under a contract is designated property to the customer if it is real property or tangible personal
property that satisfies the classification thresholds described in paragraph (b)(1)(ii) of this section. If property produced under a contract will become part of a unit of designated property produced by the customer in the customer’s hands, the property produced under the contract is designated property to the customer.

(ii) **Contractor.** Property produced under a contract is designated property to the contractor if it is real property, 2-year property, or 1-year property and the property produced under the contract is not excluded by reason of paragraph (d)(2)(v) of this section.

(iii) **Definition of a contract.** For purposes of this paragraph (d)(2), contract has the same meaning as under §1.263A–2(a)(1)(ii)(B)(2).

(iv) **Determination of whether thresholds are satisfied.** In the case of tangible personal property produced under a contract, the customer and the contractor each determine under this paragraph (d)(2), whether the property satisfies the classification thresholds described in paragraph (b)(1)(ii) of this section. Thus, tangible personal property may be designated property with respect to either, or both, the customer and the contractor. The provisions of paragraph (b)(2)(iii) of this section are modified as set forth in this paragraph (d)(2)(iv) for purposes of determining whether tangible personal property produced under a contract is 2-year property or 1-year property.

(A) **Customer.** In determining a customer’s estimated cost of production, the customer takes into account costs and payments that are reasonably expected to be incurred by the customer, but does not take into account costs incurred (or to be incurred) by an unrelated contractor. In determining the customer’s estimated length of the production period, the production period is treated as beginning on the earlier of the date the contract is executed or the date that the customer’s accumulated production expenditures for the unit are at least 5 percent of the customer’s total estimated production expenditures for the unit. The customer, however, may elect to treat the production period as beginning on the date the sum of the accumulated production expenditures of the contractor (or contractors if more than one contractor is producing components for the unit of property) and of the customer are at least 5 percent of the customer’s estimated production expenditures for the unit.

(B) **Contractor.** In determining a contractor’s estimated cost of production, the contractor takes into account only the costs that are reasonably expected to be incurred by the contractor, without any reduction for payments from the customer. In determining the contractor’s estimated length of the production period, the production period is treated as beginning on the date the contractor’s accumulated production expenditures (without any reduction for payments from the customer) are at least 5 percent of the contractor’s total estimated accumulated production expenditures.

(v) **Exclusion for property subject to long-term contract rules.** Property described in paragraph (b) of this section is designated property with respect to a contractor only if—

(A) The contract is not a long-term contract (within the meaning of section 460(f)); or

(B) The contract is a home construction contract (within the meaning of section 460(e)(6)(A)) with respect to which the requirements of section 460(e)(1)(B) (i) and (ii) are not met.

(3) **Improvements to existing property**—

(i) **In general.** Any improvement to property described in §1.263(a)–1(b) constitutes the production of property. Generally, any improvement to designated property constitutes the production of designated property. An improvement is not treated as the production of designated property, however, if the de minimis exception described in paragraph (b)(4) of this section applies to the improvement. In addition, paragraph (d)(3)(iii) of this section applies to tangible personal property. Incidental maintenance and repairs are not treated as improvements under this paragraph (d)(3). See §1.162–4.

(ii) **Real property.** The rehabilitation or preservation of a standing building, the clearing of raw land prior to sale, and the drilling of an oil well are activities constituting improvements to
real property and, therefore, the production of designated property. Similarly, the demolition of a standing building generally constitutes an activity that is an improvement to real property and, therefore, the production of designated property. See the exceptions, however, in paragraphs (b)(3) and (b)(4) of this section.

(iii) Tangible personal property. If the taxpayer has treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property regardless of the remaining useful life of the improved property (or the improvement) and, except as provided in paragraph (b)(4) of this section, regardless of the estimated length of the production period or the estimated cost of the improvement. If the taxpayer has not treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property only if the improvement independently meets the classification thresholds described in paragraph (b)(1)(ii) of this section.


§ 1.263A–9 The avoided cost method.

(a) In general—(1) Description. The avoided cost method described in this section must be used to calculate the amount of interest required to be capitalized under section 263A(f). Generally, any interest that the taxpayer theoretically would have avoided if accumulated production expenditures (as defined in §1.263A–11) had been used to repay or reduce the taxpayer's outstanding debt must be capitalized under the avoided cost method. The application of the avoided cost method does not depend on whether the taxpayer actually would have used the amounts expended for production to repay or reduce debt. Instead, the avoided cost method is based on the assumption that debt of the taxpayer would have been repaid or reduced without regard to the taxpayer's subjective intentions or to restrictions (including legal, regulatory, contractual, or other restrictions) against repayment or use of the debt proceeds.

(2) Overview—(i) In general. For each unit of designated property (within the meaning of §1.263A–8(b)), the avoided cost method requires the capitalization of—

(A) The traced debt amount under paragraph (b) of this section, and

(B) The excess expenditure amount under paragraph (c) of this section.

(ii) Rules that apply in determining amounts. The traced debt and excess expenditure amounts are determined for each taxable year or shorter computation period that includes the production period (as defined in §1.263A–12) of a unit of designated property. Paragraph (d) of this section provides an election not to trace debt to specific units of designated property. Paragraph (f) of this section provides rules for selecting the computation period, for calculating averages, and for determining measurement dates within the computation period. Special rules are in paragraph (g) of this section.

(3) Definitions of interest and incurred. Except as provided in the case of certain expenses that are treated as a substitute for interest under paragraphs (c)(2)(iii) and (g)(2)(iv) of this section, interest refers to all amounts that are characterized as interest expense under any provision of the Code, including, for example, sections 482, 483, 1272, 1274, and 7872. Incurred refers to the amount of interest that is properly accruable during the period of time in question determined by taking into account the loan agreement and any applicable provisions of the Internal Revenue laws and regulations such as section 163, §1.446–2, and sections 1271 through 1275.

(4) Definition of eligible debt. Except as provided in this paragraph (a)(4), eligible debt includes all outstanding debt (as evidenced by a contract, bond, debenture, note, certificate, or other evidence of indebtedness). Eligible debt does not include—

(i) Debt (or the portion thereof) bearing interest that is disallowed under a provision described in §1.163–8T(m)(7)(i)(I);

(ii) Debt, such as accounts payable and other accrued items, that bears no interest, except to the extent that such debt is traced debt (as defined in paragraph (b)(2) of this section);
(iii) Debt that is borrowed directly or indirectly from a person related to the taxpayer and that bears a rate of interest that is less than the applicable Federal rate in effect under section 1274(d) on the date of issuance;

(iv) Debt (or the portion thereof) bearing personal interest within the meaning of section 163(h)(2);

(v) Debt (or the portion thereof) bearing qualified residence interest within the meaning of section 163(h)(3);

(vi) Debt incurred by an organization that is exempt from Federal income tax under section 501(a), except to the extent interest on such debt is directly attributable to an unrelated trade or business of the organization within the meaning of section 512;

(vii) Reserves, deferred tax liabilities, and similar items that are not treated as debt for Federal income tax purposes, regardless of the extent to which the taxpayer's applicable financial accounting or other regulatory reporting principles require or support treating these items as debt;

(viii) Federal, State, and local income tax liabilities, deferred tax liabilities under section 453A, and hypothetical tax liabilities under the lookback method of section 460(b) or similar provisions; and

(ix) A purchase money obligation given by the lessor to the lessee (or a party that is related to the lessee) in a sale and leaseback transaction involving an agreement qualifying as a lease under §5.168(f)(8)-1 through §5.168(f)(8)-11 of this chapter. See §5c.168(f)(8)-1(e) Example (2) of this chapter.

(b) Traced debt amount—(1) General rule. Interest must be capitalized with respect to a unit of designated property in an amount (the traced debt amount) equal to the total interest incurred on the traced debt during each measurement period (as defined in paragraph (f)(2)(iii) of this section) that ends on a measurement date described in paragraph (f)(2)(iii) of this section. See the example in paragraph (b)(3) of this section. If any interest incurred on the traced debt is not taken into account for the taxable year that includes the measurement period because of a deferral provision, see paragraph (g)(2) of this section for the time and manner for capitalizing and recovering that amount. This paragraph (b)(1) does not apply if the taxpayer elects under paragraph (d) of this section not to trace debt.

(2) Identification and definition of traced debt. On each measurement date described in paragraph (f)(2)(iii) of this section, the taxpayer must identify debt that is traced debt with respect to a unit of designated property. On each such date, traced debt with respect to a unit of designated property is the outstanding eligible debt (as defined in paragraph (a)(4) of this section) that is allocated, on that date, to accumulated production expenditures with respect to the unit of designated property under the rules of §1.163–8T. Traced debt also includes unpaid interest that has been capitalized with respect to such unit under paragraph (b)(1) of this section and that is included in accumulated production expenditures on the measurement date.

(3) Example. The provisions of paragraphs (b)(1) and (b)(2) of this section are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts a taxable year computation period and quarterly measurement dates. Production of unit A starts on January 1, 1995, and ends on June 30, 1995. Corporation X has outstanding a $1,000,000 loan that is allocated under the rules of §1.163–8T to production expenditures with respect to unit A. During the period January 1, 1995, through June 30, 1995, Corporation X incurs $50,000 of interest related to the loan. Under paragraph (b)(1) of this section, the $50,000 of interest Corporation X incurs on the loan during the period January 1, 1995, through June 30, 1995, must be capitalized with respect to unit A.

(c) Excess expenditure amount—(1) General rule. If there are accumulated production expenditures in excess of traced debt with respect to a unit of designated property on any measurement date described in paragraph (f)(2)(iii) of this section, the amount by which such accumulated production expenditures exceed the traced debt (the excess expenditure amount) must be calculated under this paragraph (c)(1). However, if
the sum of the excess expenditure amounts for all units of designated property of a taxpayer exceeds the total interest described in paragraph (c)(2) of this section, only a prorata amount (as determined under paragraph (c)(7) of this section) of such interest must be capitalized with respect to each unit. For each unit of designated property, the excess expenditure amount for a computation period equals the product of—

(i) The average excess expenditures (as determined under paragraph (c)(5)(ii) of this section) for the unit of designated property for that period, and

(ii) The weighted average interest rate (as determined under paragraph (c)(5)(iii) of this section) for that period.

(2) Interest required to be capitalized. With respect to an excess expenditure amount, interest incurred during the computation period is capitalized from the following sources and in the following sequence but not in excess of the excess expenditure amount for all units of designated property:

(i) Interest incurred on nontraced debt (as defined under paragraph (c)(5)(i) of this section); and

(ii) Interest incurred on borrowings described in paragraph (a)(4)(iii) of this section (relating to certain borrowings from related persons); and

(iii) In the case of a partnership, guaranteed payments for the use of capital (within the meaning of section 707(c)) that would be deductible by the partnership if section 263A(f) did not apply.

(3) Example. The provisions of paragraph (c)(1) and (2) of this section are illustrated by the following example.

Example. In 1995, Corporation X begins, but does not complete, the construction of two office buildings that are separate units of designated property, the debt is included in nontraced debt on measurement dates before the first or after the last measurement date for that unit of designated property. Thus, nontraced debt may include debt that was previously treated as traced debt or that will be treated as traced debt on a future measurement date.

(B) Example. The provisions of paragraph (c)(5)(i)(A) of this section are illustrated by the following example.

Example. In 1995, Corporation X begins, but does not complete, the construction of two office buildings that are separate units of designated property as defined in §1.263A–10.
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(Property D and Property E). At the beginning of 1995, X borrows $2,500,000 (the $2,500,000 loan), which will be used exclusively to finance production expenditures for Property D. Although interest is paid currently, the entire principal amount of the loan remains outstanding at the end of 1995. Corporation X also has outstanding during all of 1995 a long-term loan with a principal amount of $2,000,000 (the $2,000,000 loan). The proceeds of the $2,000,000 loan were used exclusively to finance the production of Property C, a unit of designated property that was completed in 1994. Under the rules of paragraph (b)(2) of this section, the portion of the $2,500,000 loan allocated to accumulated production expenditures for property D at each measurement date during 1995 is treated as traced debt for that measurement date. The excess, if any, of $2,500,000 over the amount treated as traced debt at each measurement date during 1995 is treated as nontraced debt for that measurement date, even though it is expected that the entire $2,000,000 will remain outstanding on each measurement date as proceeds of the loan are used to finance additional production expenditures. In addition, the entire principal amount of the $2,000,000 loan is treated as nontraced debt for 1995, even though it was treated as traced debt with respect to Property C in a previous period.

(ii) Average excess expenditures—(A) General rule. The average excess expenditures for a unit of designated property for a computation period are computed by—

(1) Determining the amount (if any) by which accumulated production expenditures exceed traced debt at each measurement date during the computation period; and

(2) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(B) Example. The provisions of paragraph (c)(5)(ii)(A) of this section are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the tax accounting year as the computation period and quarterly measurement dates. The production period for unit A begins on January 14, 1995, and ends on June 16, 1995. On March 31, 1995, and on June 30, 1995, Corporation X has outstanding $1,000,000 of traced debt with respect to unit A. Accumulated production expenditures for unit A on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000.

Accumulated production expenditures in excess of traced debt for unit A on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000. Average excess expenditures for unit A during 1995 are therefore $250,000 ($400,000 + $600,000 + $0 + $0) / 4).

(iii) Weighted average interest rate—(A) Determination of rate. The weighted average interest rate for a computation period is determined by dividing interest incurred on nontraced debt during the period by average nontraced debt for the period.

(B) Interest incurred on nontraced debt. Interest incurred on nontraced debt during the computation period is equal to the total amount of interest incurred during the computation period on all eligible debt minus the amount of interest incurred during the computation period on traced debt. Thus, all interest incurred on nontraced debt during the computation period is included in the numerator of the weighted average interest rate, even if the underlying nontraced debt is repaid before the end of a measurement period and excluded from nontraced debt outstanding for measurement dates after repayment, in determining the denominator of the weighted average interest rate. However, see paragraph (g)(7) of this section for an election to treat eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding on that measurement date. See paragraph (a)(3) of this section for the definitions of interest and incurred.

(C) Average nontraced debt. The average nontraced debt for a computation period is computed by—

(1) Determining the amount of nontraced debt outstanding on each measurement date during the computation period; and

(2) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(D) Special rules if taxpayer has no nontraced debt or rate is contingent. If the taxpayer does not have nontraced debt outstanding during the computation period, the weighted average interest rate for purposes of applying paragraphs (c)(1) and (c)(2) of this section is the highest applicable Federal
rate in effect under section 1274(d) during the computation period. If interest is incurred at a rate that is contingent at the time the return for the year that includes the computation period is filed, the amount of interest is determined using the higher of the fixed rate of interest (if any) on the underlying debt or the applicable Federal rate in effect under section 1274(d) on the date of issuance.

(6) Examples. The following examples illustrate the principles of this paragraph (c):

Example 1. (i) W, a calendar year taxpayer, is engaged in the production of a unit of designated property during 1995. For purposes of applying the avoided cost method of this section, W uses the taxable year as the computation period. During 1995, W’s only debt is a $1,000,000 loan bearing interest at a rate of 7 percent from Y, a person that is related to W. Assuming the applicable Federal rate in effect under section 1274(d) on the date of issuance of the loan is 10 percent, the loan is not eligible debt under paragraph (a)(4) of this section. However, even though W has no eligible debt under paragraph (a)(4) of this section, the amount of interest that is attributable to the loan on March 31, 1995, and on June 30, 1995, is $1,600,000. Accumulated production expenditures on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Thus, the total interest incurred on nontraced debt is $200,000 ($600,000 of interest incurred on all eligible debt less $400,000 of interest incurred on nontraced debt). Under paragraph (c)(5)(ii) of this section, the weighted average interest rate for purposes of determining the excess expenditure amount is therefore $1,600,000(10%). Because this amount does not exceed the total amount of interest incurred on the loan, W capitalizes the excess expenditure amount described in paragraph (c)(2) of this section for all units of designated property in which the sum of the excess expenditure amounts under paragraph (c)(1) of this section, the amount of interest that is attributable to the loan on March 31, 1995, and on June 30, 1995, is $200,000.

(ii) Under paragraph (b)(1) of this section, the amount of interest capitalized with respect to traced debt is $60,000 ($30,000 for the measurement period ending March 31, 1995, and $30,000 for the measurement period ending June 30, 1995). Under paragraph (c)(5)(i)(B) of this section, the amount of interest that is attributable to the loan on March 31, 1995, and on June 30, 1995, is $200,000. Because this amount does not exceed the total amount of interest subject to capitalization under paragraph (c)(2) of this section, the weighted average interest rate is 10 percent (200,000 ÷ 2,000,000). Under paragraph (c)(1) of this section, Corporation X capitalizes the excess expenditure amount of $25,000 ($250,000 ÷ 10%), because it does not exceed the total amount of interest subject to capitalization under paragraph (c)(2) of this section ($200,000). Thus, the total interest capitalized with respect to unit A during 1995 is $85,000 ($60,000 ÷ 25%)

(7) Special rules where the excess expenditure amount exceeds incurred interest—(i) Allocation of total incurred interest to units. For a computation period in which the sum of the excess expenditure amounts under paragraph (c)(1) of this section for all units of designated property exceeds the total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c)(2) of this section, the amount of interest that is allocated to a unit of designated property is equal to the product of—

(A) The total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c)(2) of this section; and

(B) A fraction, the numerator of which is the average excess expenditure for the unit of designated property and the denominator of which is

Example 2. (i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. Production of unit A begins on January 1, 1995, and ends on December 31, 1995. Corporation X has outstanding $1,000,000 of eligible debt (loan #1) that is allocated under the rules of § 1.163-4T to production expenditures for unit A. During each of the first two quarters of 1995, $30,000 of interest is incurred on loan #1. The loan is repaid on July 1, 1995. Throughout 1995, Corporation X also has outstanding $2,000,000 of eligible debt (loan #2) which is not allocated under the rules of § 1.163-4T to the production of unit A. During 1995, $200,000 of interest is incurred on this nontraced debt. Accumulated production expenditures on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Accumulated production expenditures in excess of traced debt on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000.

(ii) Under paragraph (b)(1) of this section, the amount of interest capitalized with respect to traced debt is $60,000 ($30,000 for the measurement period ending March 31, 1995, and $30,000 for the measurement period ending June 30, 1995). Under paragraph (c)(5)(ii) of this section, the average excess expenditure amount for the unit of property is $25,000 ($250,000 ÷ 10%). Because this amount does not exceed the total amount of interest incurred on the loan, W capitalizes the excess expenditure amount described in paragraph (c)(2) of this section for all units of designated property in which the sum of the excess expenditure amounts under paragraph (c)(1) of this section, the amount of interest that is attributable to the loan on March 31, 1995, and on June 30, 1995, is $200,000. Because this amount does not exceed the total amount of interest subject to capitalization under paragraph (c)(2) of this section ($200,000), Corporation X capitalizes the excess expenditure amount of $25,000 ($250,000 ÷ 10%), because it does not exceed the total amount of interest subject to capitalization under paragraph (c)(2) of this section ($200,000). Thus, the total interest capitalized with respect to unit A during 1995 is $85,000 ($60,000 ÷ 25%).
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the sum of the average excess expenditures for all units of designated property.

(ii) Application of related person rules to average excess expenditure. Certain excess expenditures must be taken into account by the persons (if any) required to capitalize interest with respect to production expenditures of the taxpayer under applicable related person rules. For each computation period, the amount of average excess expenditures that must be taken into account by such persons for each unit of the taxpayer’s property is computed by—

(A) Determining, for the computation period, the amount (if any) by which the excess expenditure amount for the unit exceeds the amount of interest allocated to the unit under paragraph (c)(7)(i) of this section; and

(B) Dividing the excess by the weighted average interest rate for the period.

(iii) Special rule for corporations. If a corporation is related to another person for the purposes of the applicable related party rules, the District Director upon examination may require that the corporation apply this paragraph (c)(7) and other provisions of the regulations by excluding deferred interest from the total interest available for capitalization.

(d) Election not to trace debt—(1) General rule. Taxpayers may elect not to trace debt. If the election is made, the average excess expenditures and weighted average interest rate under paragraph (c)(5) of this section are determined by treating all eligible debt as nontraced debt. For this purpose, debt specified in paragraph (a)(4)(ii) of this section (e.g., accounts payable) may be included in eligible debt, provided it would be treated as traced debt but for an election under this paragraph (d). The election not to trace debt is a method of accounting that applies to the determination of capitalized interest for all designated property of the taxpayer. The making or revocation of the election is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e).

(2) Example. The provisions of paragraph (d)(1) of this section are illustrated by the following example.

Example. (i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1985 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. At each measurement date (March 31, June 30, September 30, and December 31) Corporation X has the following outstanding indebtedness:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noninterest-bearing accounts payable traced to unit A</td>
<td>$100,000</td>
</tr>
<tr>
<td>Noninterest-bearing accounts payable that are not traced to unit A</td>
<td>$300,000</td>
</tr>
<tr>
<td>Interest-bearing loans that are eligible debt within the meaning of paragraph (a)(4) of this section</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

(ii) Corporation X elects under this paragraph (d) not to trace debt. Eligible debt at each measurement date for purposes of calculating the weighted average interest rate under paragraph (c)(5)(iii) of this section is $1,000,000 ($100,000 + $900,000).

(e) Election to use external rate—(1) In general. An eligible taxpayer may elect to use the highest applicable Federal rate (AFR) under section 1274(d) in effect during the computation period plus 3 percentage points (AFR plus 3) as a substitute for the weighted average interest rate determined under paragraph (c)(5)(iii) of this section. A taxpayer that makes this election may not trace debt. The use of the AFR plus 3 as provided under this paragraph (e)(1) constitutes a method of accounting. A taxpayer makes the election to use the AFR plus 3 method by using the AFR plus 3 as the taxpayer’s weighted average interest rate, and any change to the AFR plus 3 method by a taxpayer that has never previously used the method does not require the consent of the Commissioner. Any other change to or from the use of the AFR plus 3 method under this paragraph (e)(1) (other than by reason of a taxpayer ceasing to be an eligible taxpayer) is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e). All changes to or from the AFR plus 3 method are effected on a cut-off basis.

(2) Eligible taxpayer. A taxpayer is an eligible taxpayer for a taxable year for purposes of this paragraph (e) if the average annual gross receipts of the taxpayer for the three previous taxable years do not exceed $10,000,000 (the
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$10,000,000 gross receipts test) and the taxpayer has met the $10,000 gross receipts for all prior taxable years beginning after December 31, 1994. For purposes of this paragraph (e)(2), the principles of section 263A(b)(2)(B) and (C) and §1.263A-9(b) apply in determining whether a taxpayer is an eligible taxpayer for a taxable year.

(f) Selection of computation period and measurement dates and application of averaging conventions—(1) Computation period—(i) In general. A taxpayer may (but is not required to) make the avoided cost calculation on the basis of a full taxable year. If the taxpayer uses the taxable year as the computation period, a single avoided cost calculation is made for each unit of designated property for the entire taxable year. If the taxpayer uses a computation period that is shorter than the full taxable year, an avoided cost calculation is made for each unit of designated property for each shorter computation period within the taxable year. If the taxpayer uses a shorter computation period, the computation period may not include portions of more than one taxable year and, except as provided in the case of short taxable years, each computation period within a taxable year must be the same length. In the case of a short taxable year, a taxpayer may treat a period shorter than the taxpayer’s regular computation period as the first or last computation period, or as the only computation period for the year if the year is shorter than the taxpayer’s regular computation period. A taxpayer must use the same computation periods for all designated property produced during a single taxable year.

(ii) Method of accounting. The choice of a computation period is a method of accounting. Any change in the computation period is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446-1(e).

(2) Measurement dates—(i) In general. If a taxpayer uses the taxable year as the computation period, measurement dates must occur at quarterly or more frequent regular intervals. If the taxpayer uses computation periods that are shorter than the taxable year, measurement dates must occur at least twice during each computation period and at least four times during the taxable year (or consecutive 12-month period in the case of a short taxable year). The taxpayer must use the same measurement dates for all designated property produced during a computation period. Except in the case of a computation period that differs from the taxpayer’s regular computation period by reason of a short taxable year (see paragraph (f)(1)(i) of this section), measurement dates must occur at equal intervals during each computation period that falls within a single taxable year. For any computation period that differs from the taxpayer’s regular computation period by reason of a short taxable year, the measurement dates used by the taxpayer during that period must be consistent with the principles and purposes of section 263A(f). A taxpayer is permitted to modify the frequency of measurement dates from year to year.

(ii) Measurement period. For purposes of this section, measurement period means the period that begins on the first day following the preceding measurement date and that ends on the measurement date.

(iii) Measurement dates on which accumulated production expenditures must be taken into account. The first measurement date on which accumulated production expenditures must be taken into account with respect to a unit of designated property is the first measurement date following the beginning of the production period for the unit of designated property. The final measurement date on which accumulated production expenditures with respect to a unit of designated property must be taken into account is the first measurement date following the end of the production period for the unit of designated property. Accumulated production expenditures with respect to a unit of designated property must also
(iv) More frequent measurement dates. When in the opinion of the District Director more frequent measurement dates are necessary to determine capitalized interest consistent with the principles and purposes of section 263A(f) for a particular computation period, the District Director may require the use of more frequent measurement dates. If a significant segment of the taxpayer’s production activities (the first segment) requires more frequent measurement dates than another significant segment of the taxpayer’s production activities, the taxpayer may request a ruling from the Internal Revenue Service permitting, for a taxable year and all subsequent taxable years, a segregation of the two segments and, notwithstanding paragraph (f)(2)(i) of this section, the use of the more frequent measurement dates for only the first segment. The request for a ruling must be made in accordance with any applicable rules relating to submissions of ruling requests. The request must be filed on or before the due date (including extensions) of the original Federal income tax return for the first taxable year to which it will apply.

(3) Examples. The following examples illustrate the principles of this paragraph (f):

Example 1. Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts the taxable year as its computation period and does not elect under paragraph (d) of this section not to trace debt. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each quarterly measurement date (March 31, June 30, September 30, and December 31). Under paragraph (c)(5)(i)(l) of this section, Corporation X must calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at the end of each quarter and dividing the sum of these amounts by four. Under paragraph (c)(5)(ii)(C) of this section, Corporation X must calculate average nontraced debt by determining the amount of nontraced debt outstanding at the end of each quarter and dividing the sum of these amounts by four.

Example 2. Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts a 6-month computation period with two measurement dates within each computation period. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each measurement date (March 31 and June 30 for the first computation period and September 30 and December 31 for the second computation period). Under paragraph (c)(5)(ii) of this section, Corporation X must, for each computation period, calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at each measurement date during the period and dividing the sum of these amounts by two. Under paragraph (c)(5)(iii)(C) of this section, Corporation X must calculate average nontraced debt for each computation period by determining the amount of nontraced debt outstanding at each measurement date during the period and dividing the sum of these amounts by two.

Example 3. (i) Corporation X, a calendar year taxpayer, is engaged in the production of two units of designated property during 1995. Production of Unit A starts in 1994 and ends on June 20, 1995. Production of Unit B starts on April 15, 1995, but does not end until 1996. Corporation X adopts the taxable year as its computation period and pays all interest on eligible debt in the quarter in which the interest is incurred. During 1995, Corporation X has two items of eligible debt. The debt and the manner in which it is used are as follows:

<table>
<thead>
<tr>
<th>No.</th>
<th>Principal</th>
<th>Annual rate (percent)</th>
<th>Period outstanding</th>
<th>Use of proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>9</td>
<td>1/01–9/01</td>
<td>Unit A.</td>
</tr>
<tr>
<td>2</td>
<td>2,000,000</td>
<td>11</td>
<td>6/01–12/31</td>
<td>Nontraced.</td>
</tr>
</tbody>
</table>

(ii) Based on the annual 9 percent rate of interest, Corporation X incurs $7,500 of interest during each month that Loan #1 is outstanding.

(iii) Accumulated production expenditures at the end of each quarter during 1995 are as follows:
Corporation X must first determine the amount of interest incurred on traced debt and capitalize the interest incurred on this amount (the traced debt amount). Loan #1 is allocated to Unit A on the March 31 and June 30 measurement dates. Accordingly, Loan #1 is treated as traced debt with respect to Unit A for the measurement periods beginning January 1 and ending June 30. The interest incurred on Loan #1 during the period that Loan #1 is treated as traced debt must be capitalized with respect to Unit A. Thus, $45,000 ($7,500 per month for 6 months) is capitalized with respect to Unit A.

(ii) Deferral provisions applied before this section. Interest (including contingent interest) that is subject to a deferral provision described in this paragraph (g)(1)(ii) is subject to capitalization under section 263A(f) only in the taxable year in which it would be deductible if section 263A(f) did not apply. Deferral provisions include sections 163(d), 163(j), 266, 469, and 861. If, after the application of section 263A(f), interest is deferred under sections 163(d), 163(j), 266, or 469, that interest is not subject to capitalization under section 263A(f) in any subsequent taxable year.

(e) Critical provisions applied after this section. Interest, except as otherwise provided in paragraph (g)(2), that is subject to a deferral provision described in this paragraph (g)(1)(i) of this section, is subject to capitalization under section 263A(f) with respect to the excess expenditure amount. The taxpayer must capitalize all interest that is neither investment interest under section 163(d), exempt related person interest under section 163(j), nor passive interest under section 469 before capitalizing any interest that is either investment interest, exempt related person interest, or passive interest. Any interest that is not required to be capitalized after the application of section 263A(f) is then taken into account as interest subject to sections 163(d), 163(j), 266, 469, and 861. If, after the application of section 263A(f), interest is deferred under sections 163(d), 163(j), 266, or 469, that interest is not subject to capitalization under section 263A(f) in any subsequent taxable year.

(g) Special rules—(1) Ordering rules—(i) Provisions preempted by section 263A(f). Interest must be capitalized under section 263A(f) before the application of section 263A(f). The rules described in paragraph (g)(2) of this section are not described in paragraph (g)(1)(i) of this section. In contrast to the provisions of paragraph (g)(1)(i) of this section, deferral provisions are applied before the application of section 263A(f).

(ii) Application of section 263A(f) to deferred interest—(1) In general. This paragraph (g)(2) describes the time and manner of capitalizing and recovering the deferral amount. The deferral amount for any computation period equals the sum of—

(A) The amount of interest that is incurred on traced debt that is deferred during the computation period and is not deductible for the taxable year that includes the computation period because of a deferral provision described in paragraph (g)(1)(ii) of this section, and

(B) The shortfall amount described in paragraph (c)(4) of this section.

(ii) Capitalization of deferral amount. The rules described in paragraph (g)(2)(ii) of this section apply to the deferral amount unless the taxpayer

### Table: Measurement date

<table>
<thead>
<tr>
<th>Measurement date</th>
<th>Unit A</th>
<th>Unit B</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31</td>
<td>$1,200,000</td>
<td>0</td>
</tr>
<tr>
<td>June 30</td>
<td>$1,800,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Sept. 30</td>
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<td>1,000,000</td>
</tr>
<tr>
<td>Dec. 31</td>
<td>0</td>
<td>1,600,000</td>
</tr>
</tbody>
</table>
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elects under paragraph (g)(2)(iv) of this section to capitalize substitute costs.

(iii) Deferred capitalization. If the taxpayer does not elect under paragraph (g)(2)(iv) of this section to capitalize substitute costs, deferred interest to which the deferral amount is attributable (determined under any reasonable method) is capitalized in the year or years in which the deferred interest would have been deductible but for the application of section 263A(f) (the capitalization year). For this purpose, any interest that is deferred from a prior computation period is taken into account in subsequent capitalization years in the same order in which the interest was deferred. If a unit of designated property to which previously deferred interest relates is sold before the capitalization year, the deferred interest applicable to that unit of property is taken into account in the capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the capitalization year, a unit of depreciable property to which previously deferred interest relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the capitalization year. See Example 2 of paragraph (g)(2)(v) of this section.

(iv) Substitute capitalization—(A) General rule. In lieu of deferred capitalization under paragraph (g)(2)(iii) of this section, the taxpayer may elect the substitute capitalization method described in this paragraph (g)(2)(iv). Under this method, the taxpayer capitalizes for the computation period in which interest is incurred and deferred (the deferral period) costs that would be deducted but for this paragraph (g)(2)(iv) (substitute costs). The taxpayer must capitalize an amount of substitute costs equal to the deferral amount for each unit of designated property, or if less, a prorata amount (determined in accordance with the principles of paragraph (c)(7)(i) of this section) of the total substitute costs that would be deducted during the deferral period, the amount by which substitute costs are insufficient with respect to each unit of designated property is a deferral amount carryforward to succeeding computation periods beginning with the next computation period. In any carryforward year, the taxpayer must capitalize an amount of substitute costs equal to the deferral amount carryforward or, if less, a prorata amount (determined in accordance with the principles of paragraph (c)(7)(i) of this section) of the total substitute costs that would be deducted during the carryforward year or years (the carryforward capitalization year) but for this paragraph (g)(2)(iv) (after applying the substitute cost method of this paragraph (g)(2)(iv) to the production of designated property in the carryforward period). If a unit of designated property to which the deferral amount carryforward relates is sold prior to the carryforward capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the carryforward capitalization year, a unit of depreciable property to which a deferral amount carryforward relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the carryforward capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the carryforward capitalization year. See Example 2 of paragraph (g)(2)(v) of this section.

(C) Method of accounting. The substitute capitalization method under
this paragraph (g)(2)(iv) is a method of accounting that applies to all designated property of the taxpayer. A change to or from the substitute capitalization method is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e).

(v) Examples. The following examples illustrate the application of the avoided cost method when interest is subject to a deferral provision:

Example 1. (i) Corporation X is a calendar year taxpayer and uses the taxable year as its computation period. During 1995, X is engaged in the construction of a warehouse which X will use in its storage business. The warehouse is completed and placed in service in December 1995. X’s average excess expenditures for 1995 equal $1,000,000. Throughout 1995, X’s only outstanding debt is a non traced debt of $900,000 and $1,200,000, bearing interest at 15 percent and 9 percent, respectively, per year. Of the $243,000 interest incurred during the year ([$900,000 × 15%] + [$1,200,000 × 9%]) = $135,000 + $108,000, $75,000 is deferred under section 267(a)(2).

(ii) X must first determine the amount of interest required to be capitalized under paragraph (c)(1) of this section for 1995 (the deferral period) without applying section 267(a)(2). The weighted average interest rate is 11.6 percent ([$135,000 + $108,000] = $2,100,000, and the excess expenditure amount under paragraph (c)(1) of this section is $116,000 ($1,000,000–11.6%). Under paragraph (c)(4) of this section, X must then determine the amount of interest that would be capitalized by applying paragraph (c)(2) of this section without regard to the amount of deferred interest. Disregarding deferred interest, the amount of interest available for capitalization is $158,000 ([$900,000 × 15%] + [$1,200,000 × 9%]– $75,000). Thus, the full excess expenditure amount ($116,000) is capitalized from interest that is not deferred under section 267(a)(2) and there is no shortfall amount.

Example 2. (i) The facts are the same as in Example 1, except that $140,000 of interest is deferred under section 267(a)(2) in 1995. The taxpayer does not elect to use the substitute capitalization method. This interest is also deferred in 1996 but would be deducted in 1997 if section 263A(f) did not apply. As in Example 1, the excess expenditure amount is $116,000. However, the amount of interest available for capitalization after excluding the amount of deferred interest is $103,000 ($900,000 × 15% + ($1,200,000 × 9%– $140,000). Thus, only $103,000 of interest is capitalized with respect to the warehouse in 1995. Since $116,000 of interest would be capitalized if section 267(a)(2) did not apply, the deferral amount determined under paragraphs (c)(2) and (g)(2)(i) of this section is $13,000 ($116,000 – $103,000). And $13,000 of deferred interest must be capitalized in the year in which it would be deducted if section 263A(f) did not apply.

(ii) The $140,000 of interest deferred under section 267(a)(2) in 1995 would be deducted in 1997 if section 263A(f) did not apply. X is therefore required to capitalize an additional $13,000 of interest with respect to the warehouse in 1997 and must redetermine its basis and recovery percentage.

(3) Simplified inventory method—(i) In general. This paragraph (g)(3) provides a simplified method of capitalizing interest expense with respect to designated property that is inventory. Under this method, the taxpayer determines beginning and ending inventory and cost of goods sold applying all other capitalization provisions, including, for example, the simplified production method of §1.263A–2(b), but without regard to the capitalization of interest with respect to inventory. The taxpayer must establish a separate capital asset, however, in an amount equal to the aggregate interest capitalization amount (as defined in paragraph (g)(3)(iii)(C) of this section). Under the simplified inventory method, increases in the aggregate interest capitalization amount from one year to the next generally are treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold.

(ii) General rule. Under the simplified inventory method, the taxpayer first separates its total ending inventory value into segments that are equal to the total ending inventory value divided by the inverse inventory turnover rate. Each inventory segment is then assigned an age starting with one year and increasing by one year for each additional segment. The inverse inventory turnover rate is determined by finding the average of beginning and ending inventory, dividing the average by the cost of goods sold for the year, and rounding the result to the nearest whole number. Beginning and ending inventory amounts are determined using total current cost of inventory for the year (rather than carrying value). Cost of goods sold, however,
may be determined using either total current cost or the taxpayer's inventory method. In addition, for purposes of this paragraph (g)(3)(ii), current costs for a year (and, if applicable, the cost of goods sold for the year under the taxpayer's inventory method) are determined without regard to the capitalization of interest with respect to inventory.

(B) Example. The provisions of paragraph (g)(3)(ii)(A) of this section are illustrated by the following example.

Example. X, a taxpayer using the FIFO inventory method, determines that total cost of goods sold for 1995 equals $900, and the cost of both beginning and ending inventory equals $3,000. Thus, X's inverse inventory turnover rate equals 3 (3.33 rounded to the nearest whole number). Total ending inventory of $3,000 is divided into three segments of $1,000 each. One segment is treated as 3-year-old inventory, one segment is treated as 2-year-old inventory, and one segment is treated as 1-year-old inventory.

(iii) Aggregate interest capitalization amount—(A) Computation period and weighted average interest rate. If a taxpayer elects the simplified inventory method, the taxpayer must use the taxable year as its computation period and use the weighted average interest rate determined under this paragraph (g)(3)(iii)(A) in determining the aggregate interest capitalization amount defined in paragraph (g)(3)(iii)(C) of this section and in determining the amount of interest capitalized with respect to any designated property that is not inventory. Under the simplified inventory method, the taxpayer determines the weighted average interest rate in accordance with paragraph (c)(5)(iii) of this section, treating all eligible debt (other than debt traced to noninventory property in the case of a taxpayer tracing debt) as nontraced debt (i.e., without tracing debt to inventory). A taxpayer that has elected under paragraph (e) of this section to use an external rate as a substitute for the weighted average interest rate determined under paragraph (c)(3)(ii) of this section uses the rate described in paragraph (e)(1) as the weighted average interest rate.

(B) Computation of the tentative aggregate interest capitalization amount. The weighted average interest rate is compounded annually by the number of years assigned to a particular inventory segment to produce an interest factor (applicable interest factor) for that segment. The amounts determined by multiplying the value of each inventory segment by its applicable interest factor are then combined to produce a tentative aggregate interest capitalization amount.

(C) Coordination with other interest capitalization computations—(1) In general. If the tentative aggregate interest capitalization amount for a year exceeds the aggregate interest capitalization amount (defined in paragraph (g)(3)(iii)(D) of this section) as of the close of the preceding year, then, for purposes of applying the rules of paragraph (c)(7) of this section, the excess is treated as an excess expenditure amount and the inventory to which the simplified inventory method of this paragraph (g)(3) applies is treated as a single unit of designated property. If, after these modifications, no paragraph (c)(7) interest allocation is necessary (i.e., the excess expenditure amounts for all units of designated property do not exceed the total amount of interest (including deferred interest) available for capitalization), the aggregate interest capitalization amount generally equals the tentative aggregate interest capitalization amount. If, on the other hand, a paragraph (c)(7) allocation is necessary, the tentative aggregate interest capitalization amount generally adjusted to reflect the results of that allocation (i.e., the increase in the aggregate interest capitalization amount is limited to the amount of interest allocated to inventory, reduced, however, by any substitute costs that are capitalized with respect to inventory under applicable related party rules).

(2) Deferred interest. In determining the aggregate interest capitalization amount, the tentative aggregate interest capitalization amount is adjusted (after the application of paragraph (c)(7) of this section) as appropriate to reflect the deferred interest rules of paragraph (g)(2) of this section. The tentative aggregate interest capitalization amount would be reduced, for example, by the amount of a taxpayer's
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deferred interest for a taxable year unless the taxpayer has elected the substitute capitalization method under paragraph (g)(2)(iv).

(3) Other coordinating provisions. The Commissioner may prescribe, by revenue ruling or revenue procedure, additional provisions to coordinate the election and use of the simplified inventory method with other interest capitalization requirements and methods. See §601.601(d)(2)(i)(b) of this chapter.

(D) Treatment of increases or decreases in the aggregate interest capitalization amount. Except as otherwise provided in this paragraph (g)(3)(iii)(D), increases in the aggregate interest capitalization amount from one year to the next are treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold. To the extent a taxpayer capitalizes substitute costs under either applicable related party rules or the deferred interest rules in paragraph (g)(2) of this section, increases in the aggregate interest capitalization amount are treated as reductions in applicable substitute costs, rather than interest expense.

(E) Example. The provisions of this paragraph (g)(3)(iii) are illustrated by the following example.

Example. The facts are the same as in the example in paragraph (g)(3)(ii)(B) of this section, and, in addition, X determines that its weighted average interest rate for 1995 is 10 percent. Additionally, assume that X has no deferred interest in 1995 or 1996 and no deferral amount carryforward to either 1995 or 1996. (See paragraph (g)(2) of this section.) Also assume that no allocation is necessary under paragraph (c)(7) of this section in either 1995 or 1996. Under the rules of paragraph (g)(3)(ii) of this section, X divides ending inventory into segments of $1,000 each. One segment is 1-year old inventory, one segment is 2-year old inventory, and one segment is 3-year old inventory. Under paragraph (g)(3)(ii)(B) of this section, X must compute the applicable interest factor for each segment. The applicable interest factor for the 1-year old inventory is not compounded. The applicable interest factor for the 2-year old inventory is compounded for 1 year. The applicable interest factor for the 3-year old inventory is compounded for 2 years. The interest factor applied to the 1-year old inventory segment is .1. The interest factor applied to the 2-year old inventory segment is .21 \((1.1 \times 1.1 - 1)\). The interest factor applied to the 3-year old inventory is .331 \((1.1 \times 1.1 \times 1.1 - 1)\).

Thus, the tentative aggregate interest capitalization amount for 1995 is $641 \((1,000 \times (.1 + .21 + .331))\). Because X has no deferred interest in 1995, no deferral amount carryforward to 1996, and no required allocation under paragraph (c)(7) of this section in 1995, X’s aggregate interest capitalization amount equals its $641 tentative aggregate interest capitalization amount. If, in 1996, X computes an aggregate interest capitalization amount of $750, the $109 increase in the amount from 1995 to 1996 would be treated as a reduction in interest expense for 1996.

(iv) Method of accounting. The simplified inventory method is a method of accounting that must be elected for and applied to all inventory within a single trade or business of the taxpayer (within the meaning of section 446(d) and §1.446-1(d)). This method may be elected only if the inventory in that trade or business consists only of designated property and only if the taxpayer’s inverse inventory turnover rate for that trade or business (as defined in paragraph (g)(3)(ii)(A) of this section) is greater than or equal to one. A change from or to the simplified inventory method is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446-1(e).

(4) Financial accounting method disregarded. The avoided cost method is applied under this section without regard to any financial or regulatory accounting principles for the capitalization of interest. For example, this section determines the amount of interest that must be capitalized without regard to Financial Accounting Standards Board (FASB) Statement Nos. 34, 71, and 90, issued by the Financial Accounting Standards Board, Norwalk, CT 06856-5116. Similarly, taxpayers are not permitted to net interest income and interest expense in determining the amount of interest that must be capitalized under this section with respect to certain restricted tax-exempt borrowings even though netting is permitted under FASB Statement No. 62.

(5) Treatment of intercompany transactions—(i) General rule. If interest capitalized under section 263A(f) by a
§ 1.263A–10  Unit of property.

(a) In general. The unit of property as defined in this section is used as the basis to determine accumulated production expenditures under § 1.263A–11 and the beginning and end of the production period under § 1.263A–12.

member of a consolidated group (within the meaning of § 1.1502–1(h)) with respect to a unit of designated property is attributable to a loan from another member of the group (the lending member), the intercompany transaction provisions of the consolidated return regulations do not apply to the lending member’s interest income with respect to that loan, except as provided in paragraph (g)(5)(ii) of this section. For this purpose, the capitalized interest expense that is attributable to a loan from another member is determined under any method that reasonably reflects the principles of the avoided cost method, including the traced and nontraced concepts. For purposes of this paragraph (g)(5)(i) and paragraph (g)(5)(ii) of this section, in order for a method to be considered reasonable it must be consistently applied.

(ii) Special rule for consolidated group with limited outside borrowing. If, for any year, the aggregate amount of interest income described in paragraph (g)(5)(i) of this section for all members of the group with respect to all units of designated property exceeds the total amount of interest that is deductible for that year by all members of the group with respect to debt of a member owed to nonmembers (group deductible interest) after taking into account the traced and nontraced concepts. For purposes of this paragraph (g)(5)(i) and paragraph (g)(5)(ii) of this section, in order for a method to be considered reasonable it must be consistently applied.

Example. (i) P and S1 are the members of a consolidated group. In 1995, S1 begins and completes the construction of a shopping center and is required to capitalize interest with respect to the construction. S1’s average excess expenditures for 1995 are $5,000,000. Throughout 1995, S1’s only borrowings include a $6,000,000 loan from P bearing interest at an annual rate of 10 percent ($600,000 per year). Under the avoided cost method, S1 is required to capitalize interest in the amount of $500,000 ($600,000−$6,000,000=5,000,000).

(ii) P’s only borrowing from unrelated lenders is a $2,000,000 loan bearing interest at an annual rate of 10 percent ($200,000 per year). Under the principles of paragraph (g)(5)(ii) of this section, because the aggregate amount of interest described in paragraph (g)(5)(i) of this section ($500,000) exceeds the aggregate amount of currently deductible interest of the group ($200,000), the intercompany transaction provisions of the consolidated return regulations apply to the excess of $300,000 and the amount of P’s interest income that is subject to current inclusion by reason of paragraph (g)(5)(i) of this section is limited to $200,000.

(6) Notional principal contracts and other derivatives. [Reserved]

(7) 15-day repayment rule. A taxpayer may elect to treat any eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding as of that measurement date for purposes of determining traced debt, average nontraced debt, and the weighted average interest rate. This election may be made or discontinued for any computation period and is not a method of accounting.
Whether property is 1-year or 2-year property under §1.263A–8(b)(1)(ii) is also determined separately with respect to each unit of property as defined in this section.

(b) Units of real property—(1) In general. A unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property even though the common feature does not meet the functional interdependence test. When the production period begins with respect to any functionally interdependent component or any common feature of the unit of real property, the production period has begun for the entire unit of real property. See, however, paragraph (b)(5) of this section for rules under which the costs of a common feature or benefitted property are excluded from accumulated production expenditures for one or more measurement dates. The portion of land included in a unit of real property includes land on which real property (including a common feature) included in the unit is situated, land subject to setback restrictions with respect to such property, and any other contiguous portion of the tract of land other than land that the taxpayer holds for a purpose unrelated to the unit being produced (e.g., investment purposes, personal use purposes, or specified future development as a separate unit of real property).

(2) Functional interdependence. Components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of property produced for sale, components of real property are functionally interdependent if they are customarily sold as a single unit. For example, the real property components of a single-family house (e.g., the land, foundation, and walls) are functionally interdependent. In contrast, components of real property that are expected to be separately placed in service or held for resale are not functionally interdependent. Thus, dwelling units within a multi-unit building that are separately placed in service or sold (within the meaning of §1.263A–12(d)(1)) are treated as functionally independent of any other units, even though the units are located in the same building.

(3) Common features. For purposes of this section, a common feature generally includes any real property (as defined in §1.263A–8(c)) that benefits real property produced by, or for, the taxpayer or a related person, and that is not separately held for the production of income. A common feature need not be physically contiguous to the real property that it benefits. Examples of common features include streets, sidewalks, playgrounds, clubhouses, tennis courts, sewer lines, and cables that are not held for the production of income separately from the units of real property that they benefit.

(4) Allocation of costs to unit. Except as provided in paragraph (b)(5) of this section, the accumulated production expenditures for a unit of real property include, in all cases, the costs that directly benefit, or are incurred by reason of the production of, the unit of real property. Accumulated production expenditures also include the adjusted basis of property used to produce the unit of real property. The accumulated costs of a common feature or land that benefits more than one unit of real property, or that benefits designated property and property other than designated property, is apportioned among the units of designated property, or among the designated property and property other than designated property, in determining accumulated production expenditures. The apportionment of the accumulated costs of the common feature (allocable share) or land (attributable land costs) generally may be made using any method that is applied on a consistent basis and that reasonably reflects the benefits provided. For example, an apportionment based on relative costs to be incurred, relative space to be occupied, or relative fair market values may be reasonable.
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(5) Treatment of costs when a common feature is included in a unit of real property—

(i) General rule. Except as provided in this paragraph (b)(5), the accumulated production expenditures of a unit of real property include the costs of functionally interdependent components (benefitted property) and an allocable share of the cost of common features throughout the entire production period of the unit. See §1.263A–12, relating to the production period of a unit of property.

(ii) Production activity not undertaken on benefitted property—

(A) Direct production activity not undertaken—

(1) In general. The costs of land attributable to a benefitted property may be treated as not included in accumulated production expenditures for a unit of real property for measurement dates prior to the first date a production activity (direct production activity), including the clearing and grading of land, has been undertaken with respect to the land attributable to the benefitted property. Thus, the costs of land attributable to a benefitted property (as opposed to land attributable to the common features) with respect to which no direct production activities have been undertaken may be treated as not included in the accumulated production expenditures of a unit of real property even though a production activity has begun on a common feature allocable to the unit.

(2) Land attributable to a benefitted property.

For purposes of this paragraph (b)(5)(ii), land attributable to a benefitted property includes all land in the unit of real property that includes the benefitted property other than land for a common feature. (Thus, land attributable to a benefitted property does not include land attributable to a common feature.)

(B) Suspension of direct production activity after clearing and grading undertaken—

(1) General rule. This paragraph (b)(5)(ii)(B) may be used to determine the accumulated production expenditures for a unit of real property, if the only production activity with respect to a benefitted property has been clearing and grading and no further direct production activity is undertaken with respect to the benefitted property for at least 120 consecutive days (i.e., direct production activity has ceased). Under this paragraph (b)(5)(ii)(B), the accumulated production expenditures attributable to a benefitted property qualifying under this paragraph (b)(5)(ii)(B) may be excluded from the accumulated production expenditures of the unit of real property even though production continues on a common feature allocable to the unit. For purposes of this paragraph (b)(5)(ii)(B), production activity is considered to occur during any time which would not qualify as a cessation of production activities under the suspension period rules of §1.263A–12(g).

(2) Accumulated production expenditures.

If this paragraph (b)(5)(ii)(B) applies, accumulated production expenditures attributable to the benefitted property of the unit of real property may be treated as not included in the accumulated production expenditures for the unit starting with the first measurement period beginning after the first day of the 120 consecutive day period, but must be included in the accumulated production expenditures for the unit beginning in the measurement period in which direct production activity has resumed on the benefitted property. Accumulated production expenditures with respect to common features allocable to the unit of real property may not be excluded under this paragraph (b)(5)(ii)(B).

(iii) Common feature placed in service before the end of production of a benefitted property.

To the extent that a common feature with respect to which all production activities to be undertaken by, or for, a taxpayer or a related person are completed is placed in service before the end of the production period of a unit that includes an allocable share of the costs of the common feature, the costs of the common feature are not treated as included in accumulated production expenditures of the unit for measurement periods beginning after the date the common feature is placed in service.

(iv) Benefitted property sold before production completed on common feature.

If a unit of real property is sold before common features included in the unit are completed, the production period of the unit ends on the date of sale. Thus,
common feature costs actually incurred and properly allocable to the unit as of the date of sale are excluded from accumulated production expenditures for measurement periods beginning after the date of sale. Common feature costs properly allocable to the unit and actually incurred after the sale are not taken into account in determining accumulated production expenditures.

(v) Benefitted property placed in service before production completed on common feature. Where production activities remain to be undertaken on a common feature allocable to a unit of real property that includes benefitted property, the costs of the benefitted property are not treated as included in the accumulated production expenditures for the unit for measurement periods beginning after the date the benefitted property is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person with respect to the benefitted property are completed.

(6) Examples. The principles of paragraph (b) of this section are illustrated by the following examples:

Example 1. B, an individual, is in the trade or business of constructing custom-built houses for sale. B owns a 10-acre tract upon which B intends to build four houses on 2-acre lots. In addition, on the remaining 2 acres B plans to construct a perimeter road that benefits the four houses and is not held for the production of income separately from the sale of the houses. In 1995, B begins constructing the perimeter road and clears the land for one house. Under the principles of paragraph (b)(1) of this section, each planned house (including attributable land) is part of a separate unit of real property (house unit).

Under the principles of paragraph (b)(3) of this section, the perimeter road (including attributable land) constitutes a common feature with respect to each planned house (i.e., benefitted property). In accordance with paragraph (b)(1), the production period for all four house units begins when production commences on the perimeter road in 1995. In addition, under the principles of paragraph (b)(4) of this section, the accumulated production expenditures for the four house units include the allocable costs of the road. In addition, for the house with respect to which B has cleared the land, the accumulated production expenditures for the house unit include the land costs attributable to the house. See paragraph (b)(5)(i) of this section. However, the accumulated production expenditures for each of the three house units that include a house for which B has not yet undertaken a direct production activity do not include the land costs attributable to the house. See paragraph (b)(5)(ii) of this section.

Example 2. Assume the same facts as Example 1, except that B undertakes no further direct production activity with respect to the house for which the land was cleared for a period of at least 120 days but continues constructing the perimeter road during this period. In accordance with paragraph (b)(5)(ii)(B) of this section, B may exclude the accumulated production expenditures attributable to the benefitted property from the accumulated production expenditures of the house unit starting with the first measurement period that begins after the first day of the 120 consecutive day period. B must include the accumulated production expenditures attributable to the benefitted property in the accumulated production expenditures for the house unit beginning with the measurement period in which direct production resumes on the benefitted property. The house unit will continue to include the accumulated production expenditures attributable to the perimeter road during the period in which direct production activity was suspended on the benefitted property.

Example 3. (i) D, a corporation, is in the trade or business of developing commercial real property. D owns a 20-acre tract upon which D intends to build a shopping center with 150 stores. D intends to lease the stores. D will also provide on the 20 acres a 1500-car parking lot, which is not held by D for the production of income separately from the stores in the shopping center. Additionally, D will not produce any other common features as part of the project. D intends to complete the shopping center in phases and expects that each store will be placed in service independently of any other store.

(ii) Under paragraphs (b)(1) and (b)(2) of this section, each store (including attributable land) is part of a separate unit of real property (store unit). The 1500-car parking lot is a common feature benefitting each store, and D must include an allocable share of the parking lots in each store unit. See paragraphs (b)(1) and (b)(3). In accordance with paragraph (b)(5)(i), D includes in the accumulated production expenditures for each store unit during each store unit’s production period: the costs capitalized with respect to the store (including attributable land costs in accordance with paragraph (b)(5) of this section) and an allocable share of the parking lot costs (including attributable land costs in accordance with paragraph (b)(5) of this section). Under paragraph (b)(4), the portion of the parking lot costs
that is included in the accumulated production expenditures of a store unit is determined using a reasonable method of allocation.

Example 5. (i) Assume the same facts as in Example 3, except that the swimming pool is not held for the production of income separately from the condominium. X begins a project consisting of a condominium building and a convenience store for the benefit of the condominium. X intends to separately lease the convenience store. Because the convenience store is held for the production of income separately from the condominium units that it benefits, the convenience store is not a common feature with respect to the condominium building. Instead, the convenience store is a separate unit of property with a separate production period and for which a separate determination of accumulated production expenditures must be made.

Example 5. (ii) Assume the same facts as in Example 3, except that the swimming pool is not held for the production of income separately from the condominium. X begins a project consisting of a condominium building and a common swimming pool that is not held for the production of income separately from the condominium sales. The condominium building consists of 10 stories, and each story is occupied by a single condominium. Production of the swimming pool begins in January. No direct production activity is undertaken on any condominium until September, when direct production activity commences on each condominium. On December 31, 1995, 1 condominium that was completed in December has been sold, 3 condominiums that were completed in December have not been sold, and 6 condominiums are only partially complete; additionally, the swimming pool is completed. X is a calendar year taxpayer that uses a full taxable year as the computation period, and quarterly measurement dates.

(ii) Under paragraphs (b)(1) and (b)(2) of this section, each condominium (including attributable land) is part of a separate unit of real property. Under the principles of paragraph (b)(3) of this section, the swimming pool is a common feature with respect to each condominium and under paragraph (b)(4) of this section the cost of the swimming pool is allocated equally among the condominiums.

(iii) Under paragraph (b)(1) of this section, the production period of each of the 10 condominium units begins in January when production of the swimming pool begins. On X’s March 31, 1995, and June 30, 1995, measurement dates, the accumulated production expenditures for each condominium unit include the allocable costs of the swimming pool because a direct production activity has been undertaken on the condominium. See paragraph (b)(3)(i)(A) of this section. On X’s September 30, 1995, and December 31, 1995, measurement dates, the accumulated production expenditures for each unit include the allocable costs of the swimming pool, and the costs of the condominium (including attributable land costs) because a direct production activity has commenced on the condominium. See paragraph (b)(3)(i) of this section.

(iii) The production period for the condominium unit that includes the condominium that is sold as of the end of 1995 ends on the date the condominium is sold. See paragraph (b)(3)(v) of this section. The production period of each unit that is ready to be sold for sale ends when all production activities have been completed on the unit, in this case on December 31, 1995, the date that the swimming pool included in the unit is completed. See §1.263A-12(d). Accordingly, interest capitalization ceases for each such unit that is sold or ready to be held for sale as of the end of 1995 (including each unit’s allocable share of the completed swimming pool).

(iv) The production periods for the condominium units that include the condominiums that are only partially complete at the end of 1995 continue after 1995. The accumulated production expenditures for each partially completed condominium unit continue to include the costs of the condominium (including attributable land costs) in addition to the costs of an allocable share of the completed swimming pool (including attributable land costs).

(v) The production periods for the condominium units that include the condominiums that are only partially complete at the end of 1995 end on the date the condominium is sold. See paragraph (b)(3)(v) of this section. In determining the costs of an allocable share of the swimming pool included in the accumulated production expenditures for each of the 9 units include the costs of an allocable share of the swimming pool. See paragraph (b)(3)(iv) of this section. In determining the costs of an allocable share of the swimming pool included in the accumulated production expenditures for each of the 9 units, X includes all costs of the swimming pool properly allocable to each unit, including those cost incurred as of the date of the sale of unit 1 that may have been used under applicable administrative procedures (e.g., Rev. Proc. 92–29, 1992–1 C.B. 748) in determining the basis of unit 1 solely for purposes of computing gain or loss on the sale of unit 1. See §691.691(d)(2)(ii)(b) of this chapter.

Example 7. (i) Assume the same facts as in Example 5, except that X intends to lease rather than sell the condominiums and the completed swimming pool is placed in service for depreciation purposes on December 31, 1995. Additionally, assume that all 10 condominiums are partially completed at the end of 1995.
(ii) Under these facts, because the swimming pool is a common feature that is placed in service separately from the condominiums that it benefits, under paragraph (b)(5)(iii) of this section, the accumulated production expenditures of each of the condominium units do not include the costs of the allocable share of the swimming pool after 1995.

(c) Units of tangible personal property. Components of tangible personal property are a single unit of property if the components are functionally interdependent. Components of tangible personal property that are produced by, or for, the taxpayer, for use by the taxpayer or a related person, are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of tangible personal property produced for sale, components of tangible personal property are functionally interdependent if they are customarily sold as a single unit. For example, if an aircraft manufacturer customarily sells completely assembled aircraft, the unit of property includes all components of a completely assembled aircraft. If the manufacturer also customarily sells aircraft engines separately, any engines that are reasonably expected to be sold separately are treated as single units of property.

(d) Treatment of installations. If the taxpayer produces or is treated as producing any property that is installed on or in other property, the production activity and installation activity relating to each unit of property generally are not aggregated for purposes of this section. However, if the taxpayer is treated as producing and installing any property for use by the taxpayer or a related person or if the taxpayer enters into a contract requiring the taxpayer to install property for use by a customer, the production activity and installation activity are aggregated for purposes of this section.


§ 1.263A–11 Accumulated production expenditures.

(a) General rule. Accumulated production expenditures generally means the cumulative amount of direct and indirect costs described in section 263A(a) that are required to be capitalized with respect to the unit of property (as defined in §1.263A–10), including interest capitalized in prior computation periods, plus the adjusted bases of any assets described in paragraph (d) of this section that are used to produce the unit of property during the period of their use. Accumulated production expenditures may also include the basis of any property received by the taxpayer in a nontaxable transaction.

(b) When costs are first taken into account—(1) In general. Except as provided in paragraph (c)(1) of this section, costs are taken into account in the computation of accumulated production expenditures at the time and to the extent they would otherwise be taken into account under the taxpayer’s method of accounting (e.g., after applying the requirements of section 461, including the economic performance requirement of section 461(h)). Costs that have been incurred and capitalized with respect to a unit of property prior to the beginning of the production period are taken into account as accumulated production expenditures beginning on the date on which the production period of the property begins (as defined in §1.263A–12(c)). Thus, for example, the cost of raw land acquired for development, the cost of a leasehold in mineral properties acquired for development, and the capitalized cost of planning and design activities are taken into account as accumulated production expenditures beginning on the first day of the production period. For purposes of determining accumulated production expenditures on any measurement date during a computation period, the interest required to be capitalized for the computation period is deemed to be capitalized on the day immediately following the end of the computation period. For any subsequent measurement dates and computation periods, that interest is included in accumulated production expenditures. If the cost of land or common features is allocated among planned units of property that are completed in phases, any portion of the cost properly allocated to completed units is not reallocated to any incomplete units of property.
(2) Dedication rule for materials and supplies. The costs of raw materials, supplies, or similar items are taken into account as accumulated production expenditures when they are incurred and dedicated to production of a unit of property. Dedicated means the first date on which the raw materials, supplies, or similar items are specifically associated with the production of any unit of property, including by record, assignment to the specific job site, or physical incorporation. In contrast, in the case of a component or subassembly that is reasonably expected to be become a part of (e.g., be incorporated into) any unit of property, costs incurred (including dedicated raw materials) for the component or subassembly are taken into account as accumulated production expenditures during the production of any portion of the component or subassembly and prior to its connection with (e.g., incorporation into) any specific unit of property. For purposes of the preceding sentence, components and subassemblies must be aggregated at each measurement date in a reasonable manner that is consistent with the purposes of section 263A(f).

(c) Property produced under a contract—(1) Customer. If a unit of property produced under a contract is designated property under §1.263A–8(d)(2)(i) with respect to the customer, the customer's accumulated production expenditures include any payments under the contract that represent part of the purchase price of the unit of designated property or, to the extent costs are incurred earlier than payments are made (determined on a cumulative basis for each unit of designated property), any part of such price for which the requirements of section 461 have been satisfied. The customer has made a payment under this section if the transaction would be considered a payment by a taxpayer using the cash receipts and disbursements method of accounting. A taxpayer apportions the adjusted basis of an asset used in the production of more than one unit of designated property among such units of designated property using reasonable criteria corresponding to the use of the asset, such as machine hours, mileage, or units of production. If an asset used in a reasonably proximate manner for the production of a unit of designated property is temporarily idle (within the meaning of §1.263A–1(e)(3)(iii)(E)) for an entire measurement period, the adjusted basis of the asset is excluded from the accumulated production expenditures for the unit during that measurement period. Notwithstanding this paragraph (d)(1), the portion of the depreciation allowance for equipment, facilities, or any other asset that is capitalized with respect to a unit of designated property in accordance with §1.263A–1(e)(3)(ii)(I) is included in accumulated production expenditures without regard to the extent of use under
this paragraph (d)(1) (i.e., without regard to whether the asset is used in a reasonably proximate manner for the production of the unit of designated property).

(2) Example. The following example illustrates how the basis of an asset is allocated on the basis of time:

Example. In 1995, X uses a bulldozer exclusively to clear the land on several adjacent real estate development projects, A, B, and C. A, B, and C are treated as separate units of property under the principles of §1.263A–10. X decides to allocate the basis of the bulldozer among the three projects on the basis of time. At the end of the first quarter of 1995, the production period has commenced for all three projects. The bulldozer was operated for 30 hours on project A, 80 hours on project B, and 10 hours on project C, for a total of 120 hours for the entire period. For purposes of determining accumulated production expenditures as of the end of the first quarter, 1⁄4 of the adjusted basis of the bulldozer is allocated to project A, 2⁄3 to project B, and 1⁄12 to project C. Nonworking hours, regularly scheduled nonworking days, or other periods in which the bulldozer is temporarily idle (within the meaning of §1.263A–1(e)(3)(iii)(E)) during the measurement period are not taken into account in allocating the basis of the bulldozer.

(3) Excluded equipment and facilities. The adjusted bases of equipment, facilities, or other assets that are not used in a reasonably proximate manner to produce a unit of property are not included in the computation of accumulated production expenditures. For example, the adjusted bases of equipment and facilities, including buildings and other structures, used in service departments performing administrative, purchasing, personnel, legal, accounting, or similar functions, are excluded from the computation of accumulated production expenditures under this paragraph (d)(3).

(e) Improvements—(1) General rule. If an improvement constitutes the production of designated property under §1.263A–8(d)(3), accumulated production expenditures with respect to the improvement consist of—

(i) All direct and indirect costs required to be capitalized with respect to the improvement,

(ii) In the case of an improvement to a unit of real property—

(A) An allocable portion of the cost of land, and

(B) For any measurement period, the adjusted basis of any existing structure, common feature, or other property that is not placed in service or must be temporarily withdrawn from service to complete the improvement (associated property) during any part of the measurement period if the associated property directly benefits the property being improved, the associated property directly benefits from the improvement, or the improvement was incurred by reason of the associated property. See, however, the de minimis rule under paragraph (e)(2) of this section that applies in the case of associated property.

(iii) In the case of an improvement to a unit of tangible personal property, the adjusted basis of the asset being improved if that asset either is not placed in service or must be temporarily withdrawn from service to complete the improvement.

(2) De minimis rule. For purposes of paragraph (e)(1)(ii) of this section, the total costs of all associated property for an improvement unit (associated property costs) are excluded from the accumulated production expenditures for the improvement unit during its production period if, on the date the production period of the unit begins, the taxpayer reasonably expects that at no time during the production period of the unit will the accumulated production expenditures for the unit, determined without regard to the associated property costs, exceed 5 percent of the associated property costs.

(f) Mid-production purchases. If a taxpayer purchases a unit of property for further production, the taxpayer's accumulated production expenditures include the full purchase price of the property plus, in accordance with the principles of paragraph (e) of this section, additional direct and indirect costs incurred by the taxpayer.

(g) Related person costs. The activities of a related person are taken into account in applying the classification thresholds under §1.263A–8(b)(1)(i)(B) and (C), and in determining the production period of a unit of designated property under §1.263A–12. However, only those costs incurred by the taxpayer are taken into account in the
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taxpayer’s accumulated production expenditures under this section because the related person includes its own capitalized costs in the related person’s accumulated production expenditures with respect to any unit of designated property upon which the parties engage in mutual production activities. For purposes of the preceding sentence, the accumulated production expenditures of any property transferred to a taxpayer in a nontaxable transaction are treated as accumulated production expenditures incurred by the taxpayer.  

(h) Installation. If the taxpayer installs property that is purchased by the taxpayer, accumulated production expenditures include the cost of the property that is installed in addition to the direct and indirect costs of installation.  


§ 1.263A–12 Production period.  

(a) In general. Capitalization of interest is required under §1.263A–9 for computation periods (within the meaning of §1.263A–9(f)(1)) that include the production period of a unit of designated property. In contrast, section 263A(a) requires the capitalization of all other direct or indirect costs, such as insurance, taxes, and storage, that directly benefit or are incurred by reason of the production of property without regard to whether they are incurred during a period in which production activity occurs.  

(b) Related person activities. Activities performed and costs incurred by a person related to the taxpayer that directly benefit or are incurred by reason of the taxpayer’s production of designated property are taken into account in determining the taxpayer’s production period (regardless of whether the related person is performing only a service or is producing a subassembly or component that the related person is required to treat as an item of designated property). These activities and the related person’s costs are also taken into account in determining whether tangible personal property produced by the taxpayer is 1-year or 2-year property under §1.263A–8(b)(1)(ii) (B) and (C).  

(c) Beginning of production period—(1) In general. A separate production period is determined for each unit of property defined in §1.263A–10. The production period begins on the date that production of the unit of property begins.  

(2) Real property. The production period of a unit of real property begins on the first date that any physical production activity (as defined in paragraph (e) of this section) is performed with respect to a unit of real property. See §1.263A–10(b)(1). The production period of a unit of real property produced under a contract begins for the contractor on the date the contractor begins physical production activity on the property. The production period of a unit of real property produced under a contract begins for the customer on the date either the customer or the contractor begins physical production activity on the property.  

(3) Tangible personal property. The production period of a unit of tangible personal property begins on the first date by which the taxpayer’s accumulated production expenditures, including planning and design expenditures, are at least 5 percent of the taxpayer’s total estimated accumulated production expenditures for the property unit. Thus, the beginning of the production period is determined without regard to whether physical production activity has commenced. The production period of a unit of tangible personal property produced under a contract begins for the contractor when the contractor’s accumulated production expenditures, without any reduction for payments from the customer, are at least 5 percent of the contractor’s total estimated accumulated production expenditures. The production period for a unit of tangible personal property produced under a contract begins for the customer when the customer’s accumulated production expenditures are at least 5 percent of the customer’s total estimated accumulated production expenditures.  

(d) End of production period—(1) In general. The production period for a unit of property produced for self use ends on the date that the unit is placed in service and all production activities reasonably expected to be undertaken
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by, or for, the taxpayer or a related person are completed. The production period for a unit of property produced for sale ends on the date that the unit is ready to be held for sale and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See, however, §1.263A-10(b)(5)(iv) providing an exception for common features in the case of a beneficially owned property that is sold. In the case of a unit of property produced under a contract, the production period for the customer ends when the property is placed in service by the customer and all production activities reasonably expected to be undertaken are complete (i.e., generally, no earlier than when the customer takes delivery). In the case of property that is customarily aged (such as tobacco, wine, or whiskey) before it is sold, the production period includes the aging period.

(2) Special rules. The production period does not end for a unit of property prior to the completion of physical production activities by the taxpayer even though the property is held for sale or lease, since all production activities reasonably expected to be undertaken by the taxpayer with respect to such property have not in fact been completed. See, however, §1.263A-10(b)(5) regarding separation of certain common features.

(3) Sequential production or delivery. The production period ends with respect to each unit of property (as defined in §1.263A-10) and its associated accumulated production expenditures as the unit of property is completed within the meaning of paragraph (d)(1) of this section, without regard to the production activities or costs of any other units of property. Thus, for example, in the case of separate apartments in a multi-unit building, each of which is a separate unit of property within the meaning of §1.263A-10, the production period ends for each separate apartment when it is ready to be held for sale or placed in service within the meaning of paragraph (d)(1) of this section. In the case of a single unit of property that merely undergoes separate and distinct stages of production, the production period ends at the same time (i.e., when all separate stages of production are completed with respect to the entire amount of accumulated production expenditures for the property).

(4) Examples. The provisions of paragraph (d) of this section are illustrated by the following examples:

Example 1. E is engaged in the original construction of a high-rise office building with two wings. At the end of 1995, Wing #1, but not Wing #2, is placed in service. Moreover, at the end of 1995, all production activities reasonably expected to be undertaken on Wing #1 are completed. In accordance with §1.263A-10(b)(1), Wing #1 and Wing #2 are separate units of designated property. E may stop capitalizing interest on Wing #1 but not on Wing #2.

Example 2. F is in the business of constructing finished houses. F generally paints and finishes the interior of the house, although this does not occur until a potential buyer is located. Because F reasonably expects to undertake production activity (painting and finishing), the production period of each house does not end until these activities are completed.

(e) Physical production activities—(1) In general. The term physical production activities includes any physical activity that constitutes production within the meaning of §1.263A-8(d)(1). The production period begins and interest must be capitalized with respect to real property if any physical production activities are undertaken, whether alone or in preparation for the construction of buildings or other structures, or with respect to the improvement of existing structures. For example, the clearing of raw land constitutes the production of designated property, even if only cleared prior to resale.

(2) Illustrations. The following is a partial list of activities any one of which constitutes a physical production activity with respect to the production of real property:

(i) Clearing, grading, or excavating of raw land;

(ii) Demolishing a building or gutting a standing building;

(iii) Engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables, and wiring;

(iv) Undertaking structural, mechanical, or electrical activities with respect to a building or other structure; or

(v) Engaging in landscaping activities.
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(f) Activities not considered physical production. The activities described in paragraphs (f)(1) and (f)(2) of this section are not considered physical production activities:

(1) Planning and design. Soil testing, preparing architectural blueprints or models, or obtaining building permits.

(2) Incidental repairs. Physical activities of an incidental nature that may be treated as repairs under §1.162–4.

(g) Suspension of production period—(1) In general. If production activities related to the production of a unit of designated property cease for at least 120 consecutive days (cessation period), a taxpayer may suspend the capitalization of interest with respect to the unit of designated property starting with the first measurement period that begins after the first day in which production ceases. The taxpayer must resume the capitalization of interest with respect to a unit beginning with the measurement period during which production activities resume. In addition, production activities are not considered to have ceased if they cease because of circumstances inherent in the production process, such as normal adverse weather conditions, scheduled plant shutdowns, or delays due to design or construction flaws, the obtaining of a permit or license, or the settlement of groundfill to construct property. Interest incurred on debt that is traced with respect to a unit of designated property during the suspension period is subject to capitalization with respect to the production of other units of designated property as interest on nontraced debt. See §1.263A–9(c)(5)(i) of this section. For applications of the avoided cost method after the end of the suspension period, the accumulated production expenditures for the unit include the balance of accumulated production expenditures as of the beginning of the suspension period, plus any additional capitalized costs incurred during the suspension period. No further suspension of interest capitalization may occur unless the requirements for a new suspension period are satisfied.

(2) Special rule. If a cessation period spans more than one taxable year, the taxpayer may suspend the capitalization of interest with respect to a unit beginning with the first measurement period of the taxable year in which the 120-day period is satisfied.

(3) Method of accounting. An election to suspend interest capitalization under paragraph (g)(1) of this section is a method of accounting that must be consistently applied to all units that satisfy the requirements of paragraph (g)(1) of this section. However, the special rule in paragraph (g)(2) of this section is applied on an annual basis to all units of an electing taxpayer that satisfy the requirements of paragraph (g)(2) of this section.

(4) Example. The provisions of paragraph (g)(1) of this section are illustrated by the following example.

Example. (i) D, a calendar-year taxpayer, began production of a residential housing development on January 1, 1995. D, in applying the avoided cost method, chose a taxable year computation period and quarterly measurement dates. On April 10, 1995, all production activities ceased with respect to the units in the development until December 1, 1996. The cessation, which occurred for a period of at least 120 consecutive days, was not attributable to circumstances inherent in the production process. With respect to the units in the development, D incurred production expenditures of $2,000,000 from January 1, 1995 through April 10, 1995. D incurred interest of $100,000 on traced debt attributable to circumstances inherent in the production process. With respect to the units in the development, D incurred production expenditures of $2,000,000 from January 1, 1995 through April 10, 1995. D incurred interest of $100,000 on traced debt with respect to the units for the period beginning January 1, 1995, and ending June 30, 1995. D did not incur any production expenditures for the more than 20-month cessation beginning April 10, 1995, and ending December 1, 1996, but incurred $200,000 of production expenditures from December 1, 1996, through December 31, 1996.

(ii) D is required to capitalize the $100,000 interest on traced debt incurred during the two measurement periods beginning January 1, 1995, and ending June 30, 1995. Because D satisfied the 120-day rule under this paragraph (g), D is not required to capitalize interest with respect to the accumulated production expenditures for the units for the measurement period beginning July 1, 1995, and ending September 30, 1995, which is the first measurement period that begins after the date production activities cease. D is required to resume interest capitalization with respect to the $2,300,000 (2,000,000+100,000+200,000) of accumulated production expenditures for the units for the measurement period beginning October 1,
§ 1.263A-13 Oil and gas activities.

(a) In general. This section provides rules that are to be applied in tandem with §1.263A-8 through 1.263A-12, 1.263A-14, and 1.263A-15 in capitalizing interest with respect to the development (within the meaning of section 263A(g)) of oil or gas property. For this purpose, oil or gas property consists of each separate operating mineral interest in oil or gas as described in section 614(a), or, if a taxpayer makes an election under section 614(b), the aggregate of two or more separate operating mineral interests in oil or gas as described in section 614(b) (section 614 property). Thus, an oil or gas property is designated property unless the de minimis rule applies. A taxpayer must apply the rules in paragraph (c) of this section if the taxpayer cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of the wells planned with respect to the property. A taxpayer can establish such a plan at the beginning of the production period for a productive unit on the date the well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See §1.263A-12(d).

(b) Generally applicable rules—(1) Beginning of production period—(i) Onshore activities. In the case of onshore oil or gas development activities, the production period for a unit begins on the first date physical site preparation activities (such as building an access road, leveling a site for a drilling rig, or excavating a mud pit) are undertaken with respect to the unit.

(ii) Offshore activities. In the case of offshore development activities, the production period for a unit begins on the first date physical site preparation activities, other than activities undertaken with respect to expendable wells, are undertaken with respect to the unit. For purposes of the preceding sentence, the first physical site preparation activity undertaken with respect to a section 614 property is generally the first activity undertaken with respect to the anchoring of a platform (e.g., drilling to drive the piles). For purposes of this section, an expendable well is a well drilled solely to determine the location and delineation of offshore hydrocarbon deposits.

(2) End of production period. The production period ends for a productive unit on the date the well is placed in service and all production activities are undertaken with respect to that well unit.

(3) Accumulated production expenditures—(i) Costs included. Accumulated production expenditures for a well unit include the following costs (to the extent they are not intangible drilling and development costs allowable as a deduction under section 263(c), 263(i), or 291(b)(2)): the costs of acquiring the section 614 leasehold and the costs of taxes and similar items that are required to be capitalized under section 263A(a) with respect to the section 614 leasehold; the cost of real property associated with developing the section 614 property (e.g., casing); the basis of real property that constitutes a common feature within the meaning of §1.263A-10(b)(3); and the adjusted basis of property used to produce property (such as a mobile rig, drilling ship, or an offshore drilling platform).

(ii) Improvement unit. To the extent section 614 costs are allocated to a well unit, the undepleted portion of those section 614 costs must also be included in the accumulated production expenditures for any improvement unit (within the meaning of §1.263A-8(d)(3)) with respect to that well unit.

(c) Special rules when definite plan not established—(1) In general. The special rules of this paragraph (c) must be applied by a taxpayer that cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of the wells planned with respect to the property. A
taxpayer than can establish such a plan is permitted, but not required, to apply the rules of this paragraph (c), provided the rules of this paragraph (c) are consistently applied for all the taxpayer’s oil or gas properties for which a definite plan can be established.

(2) Oil and gas units—(i) First productive well unit. Until the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, a first productive well unit includes the section 614 property and all real property associated with the development of the section 614 property. Thus, for example, a first productive well unit includes the section 614 property and real property associated with any nonproductive well drilled on the section 614 property on or before the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. For purposes of this section, a productive well is a well that produces in commercial quantities. See paragraph (c)(5) of this section, which provides a special rule whereby the costs of a section 614 property and common feature costs for a section 614 property generally are included only in the accumulated production expenditures for the first productive well unit.

(ii) Subsequent wells. Generally, real property associated with each productive or nonproductive well with respect to which production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, constitutes a unit of real property. Additionally, a productive or nonproductive well that is included in a first productive well unit and for which development continues after the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, generally is treated as a separate unit of property after that date. See, however, paragraph (c)(5) of this section, which provides rules for the treatment of costs included in the accumulated production expenditures of a first productive well unit.

(3) Beginning of production period—(i) First productive well unit. The beginning of the production period of the first productive well unit is determined as provided in paragraph (b) of this section.

(ii) Subsequent wells. In applying paragraph (b) of this section to subsequent well units (as described in paragraph (c)(2)(ii) of this section), any activities occurring prior to the date the production period ends for the first productive well unit are not taken into account in determining the beginning of the production period for the subsequent well units.

(4) End of production period. The end of the production period for both the first productive well unit and subsequent productive well units is determined as provided in paragraph (b)(2) of this section. See §1.263A–12(d). Nonproductive wells included in the first productive well unit need not be plugged and abandoned for the production period to end for a first productive well unit.

(5) Accumulated production expenditures—(i) First productive well unit. The accumulated production expenditures for a first productive well unit include all costs incurred with respect to the section 614 property and associated real property at any time through the end of the production period for the first productive well unit. Thus, the costs of acquiring the section 614 property, the costs of taxes and similar items that are required to be capitalized under section 263A(a) with respect to the section 614 property, and the costs of common features, that are incurred at any time through the end of the production period of the first productive well unit (section 614 costs) are included in the accumulated production expenditures for the first productive well unit.

(ii) Subsequent well unit. The accumulated production expenditures for a subsequent well do not include any costs included in the accumulated production expenditures for a first productive well unit. In the event that section 614 costs or common feature costs with respect to a section 614 property are incurred subsequent to the end of the
production period of the first productive well unit, those common feature costs and undepleted section 614 costs are allocated among the accumulated production expenditures of wells being drilled as of the date such costs are incurred.

(6) **Allocation of interest capitalized with respect to first productive well unit.** Interest attributable to any productive or nonproductive well included in the first productive well unit (within the meaning of paragraph (c)(2)(ii) of this section) is allocated among and capitalized to the basis of the property associated with the first productive well unit. See §1.263A–8(a)(2).

(7) **Example.** The provisions of this paragraph (c) are illustrated by the following example.

**Example.** Corporation Z, an oil company, acquired a section 614 property in an onshore tract, Tract B, for development. In 1995, Corporation Z began site preparation activities on Tract B and also commenced drilling Well 1 on Tract B. Corporation Z was unable to establish, as provided in paragraph (a) of this section, a definite plan identifying the number and location of other wells planned on Tract B. In 1996, Corporation Z began drilling Well 2. On May 1, 1997, Well 2, a productive well, was placed in service and all production activities reasonably expected to be undertaken with respect to Well 2 were completed. By that date, also, Well 1 was abandoned.

(i) Well 2 is a first productive well (within the meaning of paragraph (c)(2)(i) of this section). Well 1 is a nonproductive well prior to a first productive well. Under paragraph (c) of this section, Corporation Z must treat both Well 1 and Well 2 as part of the first productive well unit on the section 614 property. In accordance with paragraphs (c)(3) and (c)(4) of this section, the production period of the first productive well unit begins on the date physical site preparation activities are undertaken with respect to Well 1 in 1995 and ends on May 1, 1997, the date that Well 2 is placed in service and all production activities reasonably expected to be undertaken are completed. In accordance with paragraph (c)(5) of this section, the accumulated production expenditures for the first productive well unit include, among other capitalized costs, the entire section 614 property costs capitalized with respect to Tract B and all common feature costs incurred with respect to the section 614 property through May 1, 1997.

(ii) Any well that Corporation Z begins after May 1, 1997, is a separate unit of property. See paragraph (c)(2)(ii) of this section. Under paragraph (c)(3)(ii) of this section, the production period for any such well unit begins on the first day after May 1, 1997, on which Corporation Z undertakes physical site preparation activities with respect to the well unit. Moreover, Corporation Z does not include any of the section 614 property costs in the accumulated production expenditures for any well unit begun after May 1, 1997.


§ 1.263A–14 Rules for related persons.

Taxpayers must account for average excess expenditures allocated to related persons under applicable administrative pronouncements interpreting section 263A(f). See §601.601(d)(2)(ii)(b) of this chapter.


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

(a) **Effective dates—** (1) Sections 1.263A–8 through 1.263A–15 generally apply to interest incurred in taxable years beginning on or after January 1, 1995. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning on or after January 1, 1995. Changes in methods of accounting necessary as a result of the rules in §§1.263A–8 through 1.263A–15 must be made under the terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of §1.263A–7 must be applied in revaluing inventory property.

(2) For taxable years beginning before January 1, 1995, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A(f). For purposes of this paragraph (a)(2), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1995. See §601.601(d)(2)(ii)(b) of this chapter. For this purpose, Notice 88–99, 1988–2 C.B. 422, applies to taxable years beginning after August 17, 1988, in the case of inventory, and to interest incurred in taxable years beginning after August 17, 1988, in all other cases. Finally, under administrative procedures issued
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by the Commissioner, taxpayers may elect early application of §§1.263A–8 through 1.263A–15 to taxable years beginning on or after January 1, 1994, in the case of inventory property, and to interest incurred in taxable years beginning on or after January 1, 1994, in the case of property that is not inventory in the hands of the taxpayer.

(3) Section 1.263A–9(a)(4)(ix) generally applies to interest incurred in taxable years beginning on or after May 20, 2004. In the case of property that is inventory in the hands of the taxpayer, §1.263A–9(a)(4)(ix) applies to taxable years beginning on or after May 20, 2004. Taxpayers may elect to apply §1.263A–9(a)(4)(ix) to interest incurred in taxable years beginning on or after January 1, 1995, or, in the case of property that is inventory in the hands of the taxpayer, to taxable years beginning on or after January 1, 1995. A change in a taxpayer’s treatment of interest to a method consistent with §1.263A–9(a)(4)(ix) is a change in method of accounting to which sections 446 and 481 apply.

(b) Transitional rule for accumulated production expenditures—(1) In general. Except as provided in paragraph (b)(2) of this section, costs incurred before the effective date of section 263A are included in accumulated production expenditures (within the meaning of §1.263A–11) with respect to noninventory property only to the extent those costs were required to be capitalized under section 263 when incurred and would have been taken into account in determining the amount of interest required to be capitalized under former section 189 (relating to the capitalization of real property interest and taxes) or pursuant to an election that was in effect under section 266 (relating to the election to capitalize certain carrying charges).

(2) Property used to produce designated property. The basis of property acquired prior to 1987 and used to produce designated noninventory property after December 31, 1986, is included in accumulated production expenditures in accordance with §1.263A–11(d) without regard to whether the basis would have been taken into account under former section 189 or section 266.

(c) Anti-abuse rule. The interest capitalization rules contained in §§1.263A–8 through 1.263A–15 must be applied by the taxpayer in a manner that is consistent with and reasonably carries out the purposes of section 263A(f). For example, in applying §1.263A–10, regarding the definition of a unit of property, taxpayers may not divide a single unit of property to avoid property classifying the property as designated property. Similarly, taxpayers may not use loans in lieu of advance payments, tax-exempt parties, loan restructurings at measurement dates, or obligations bearing an unreasonably low rate of interest (even if such rate equals or exceeds the applicable Federal rate under section 1274(d)) to avoid the purposes of section 263A(f). For purposes of this paragraph (c), the presence of back-to-back loans with different rates of interest, and other uses of related parties to facilitate an avoidance of interest capitalization, evidences abuse. In such cases, the District Director may, based upon all the facts and circumstances, determine the amount of interest that must be capitalized in a manner that is consistent with and reasonably carries out the purposes of section 263A(f).


§ 1.264–1 Premiums on life insurance taken out in a trade or business.

(a) When premiums are not deductible. Premiums paid by a taxpayer on a life insurance policy are not deductible from the taxpayer’s gross income, even though they would otherwise be deductible as trade or business expenses, if they are paid on a life insurance policy covering the life of any officer or employee of the taxpayer, or any person (including the taxpayer) who is financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary of the policy. For additional provisions relating to the nondeductibility of premiums paid on life insurance policies (whether under section 162 or any other section of the Code), see section 262, relating to personal, living, and family expenses, and section 265, relating to expenses allocable to tax-exempt income.
(b) When taxpayer is a beneficiary. If a taxpayer takes out a policy for the purpose of protecting himself from loss in the event of the death of the insured, the taxpayer is considered a beneficiary directly or indirectly under the policy. However, if the taxpayer is not a beneficiary under the policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. See section 162 and the regulations thereunder. A taxpayer is considered a beneficiary under a policy where, for example, he, as a principal member of a partnership, takes out an insurance policy on his own life irrevocably designating his partner as the sole beneficiary in order to induce his partner to retain his investment in the partnership. Whether or not the taxpayer is a beneficiary under a policy, the proceeds of the policy paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, except in the case of (1) certain transferees, as provided in section 101(a)(2); (2) portions of amounts of life insurance proceeds received at a date later than death under the provisions of section 101(d); and (3) life insurance policy proceeds which are includible in the gross income of a husband or wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.). (See section 101(e).) For further reference, see, generally, section 101 and the regulations thereunder.

§ 1.264–2 Single premium life insurance, endowment, or annuity contracts.

Amounts paid or accrued on indebtedness incurred or continued, directly or indirectly, to purchase or to continue in effect a single premium life insurance, endowment, or annuity contract purchased (whether from the insurer, annuitant, or any other person) after March 1, 1954, are not deductible under section 163 or any other provision of chapter 1 of the Code for any amount (determined under paragraph (b) of this section) paid or accrued during the taxable year on indebtedness incurred or continued to purchase or to continue in effect a single premium annuity contract purchased after March 1, 1954, and to the extent they consider a contract a single premium life insurance, endowment, or annuity contract if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

§ 1.264–3 Effective date; taxable years ending after March 1, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in §1.264–2, to the extent that they relate to amounts paid or accrued on indebtedness incurred or continued to purchase or carry a single premium annuity contract purchased after March 1, 1954, and to the extent they consider a contract a single premium life insurance, endowment, or annuity contract if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract, shall also apply to taxable years beginning before January 1, 1954, and ending after March 1, 1954, and to taxable years beginning after December 31, 1953, and ending after March 1, 1954, but before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939.

§ 1.264–4 Other life insurance, endowment, or annuity contracts.

(a) General rule. Except as otherwise provided in paragraphs (d) and (e) of this section, no deduction shall be allowed under section 163 or any other provision of chapter 1 of the Code for any amount (determined under paragraph (b) of this section) paid or accrued during the taxable year on indebtedness incurred or continued to purchase or to continue in effect a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) if such indebtedness is incurred pursuant to a plan of...
§ 1.264–4

purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise). For the purposes of the preceding sentence, the term of purchase includes the payment of part or all of the premiums on a contract, and not merely payment of the premium due upon initial issuance of the contract. The rule of this paragraph applies whether or not the taxpayer is the insured, payee, or annuitant under the contract, the rule of this paragraph does not apply to contracts purchased by the taxpayer on or before August 6, 1963, even though there is a substantial increase in premiums after such date. The rule of this paragraph does not apply to any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract (including a contract treated as a single premium contract); the treatment of such amounts is governed by § 1.264–2.

(b) Determination of amount not allowed. The amount not allowed as a deduction under paragraph (a) of this section is determined with reference to the entire amount of borrowing to purchase or carry the contract, and is not limited with reference to the amount of borrowing of increases in the cash value. The rule of this paragraph may be illustrated by the following example:

Example. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a policy in the amount of $100,000 with an annual gross premium of $2,200. For the first policy year, A pays the annual premium by means other than by borrowing. For the second, third, fourth, and fifth policy years, A continues the policy in effect by incurring indebtedness pursuant to a plan referred to in paragraph (a) of this section. The years and amounts applicable to the policy are as follows:

<table>
<thead>
<tr>
<th>Years</th>
<th>Cumulative cash value of contract</th>
<th>Total loan outstanding</th>
<th>Interest paid at 4.8 percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>$370</td>
<td>$2,200</td>
<td>$105.60</td>
</tr>
<tr>
<td>1965</td>
<td>2,175</td>
<td>$4,000</td>
<td>$211.20</td>
</tr>
<tr>
<td>1966</td>
<td>4,000</td>
<td>4,600</td>
<td>316.80</td>
</tr>
<tr>
<td>1967</td>
<td>5,865</td>
<td>6,600</td>
<td>422.40</td>
</tr>
<tr>
<td>1968</td>
<td>7,745</td>
<td>8,800</td>
<td>422.40</td>
</tr>
</tbody>
</table>

On these facts (assuming that none of the exceptions contained in paragraph (d) of this section are applicable), no deduction is allowed for the interest paid during the year 1963. Moreover, the interest deduction will be disallowed for the taxable years 1965 through 1967 if such taxable years are not closed by reason of the statute of limitations or other rule of law.

(c) Special rules. For purposes of this section:

(1) Determination of existence of a plan which contemplates systematic borrowing—(i) In general. The determination of whether indebtedness is incurred or continued pursuant to a plan referred to in paragraph (a) of this section shall be made on the basis of all the facts and circumstances in each case. Unless the taxpayer shows otherwise, in the case of borrowing in connection with premiums for more than three years, the existence of a plan referred to in paragraph (a) of this section will be presumed. The mere fact that a taxpayer does not borrow to pay a premium in a particular year does not in and of itself preclude the existence of a plan referred to in paragraph (a) of this section. A plan referred to in paragraph (a) of this section need not exist at the time the contract is entered into, but may come into existence at any time during the 7-year period following the taxpayer’s purchase of the contract or following a substantial increase (referred to in paragraph (d)(1) of this section) in premiums on the contract.

(ii) Premium attributable to more than one year. For purposes of subdivision (i) of this subparagraph, if the stated annual premiums due on a contract vary in amount, borrowing in connection with any premium, the amount of which exceeds the amount of any other premium, on such contract may be considered borrowing to pay premiums for more than one year. The preceding sentence shall not apply where the borrowing is in connection with a substantially increased premium within the meaning of paragraph (d)(1) of this section.

(2) Direct or indirect. A plan referred to in paragraph (a) of this section may contemplate direct or indirect borrowing of increases in cash value of the contract directly or indirectly to pay
premiums and many contemplate borrowing either from an insurance carrier, from a bank, or from any other person. Thus, for example, if a taxpayer borrows $100,000 from a bank and uses the funds to purchase securities, later borrows $100,000 from a second bank and uses the funds to repay the first bank, later sells the securities and uses the funds as a part of a plan referred to in paragraph (a) of this section to pay premiums on a contract of cash value life insurance, the deduction for interest paid in continuing the loan from the second bank shall not be allowed (assuming that none of the exceptions contained in paragraph (d) of this section are applicable). Moreover, a plan referred to in paragraph (a) of this section need not involve a pledge of the contract, but may contemplate unsecured borrowing or the use of other property.

(d) Exceptions. No deduction shall be denied under paragraph (a) of this section with respect to any amount paid or accrued during a taxable year on indebtedness incurred or continued as part of a plan referred to in paragraph (a) of this section if any of the following exceptions apply.

(1) The 7-year exception—(i) In general. No part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness. For purposes of this exception, in the event of a substantial increase in any annual premium on a contract, a new 7-year period begins on the date such increased premium is paid. If premiums on a contract are payable other than on an annual basis (for example, monthly), the annual premium is the aggregate of premiums due for the year. See paragraph (c)(1)(ii) of this section for cases where one premium on a contract paid by means of indebtedness may be considered as more than one annual premium.

(ii) Application of borrowings. For purposes of subdivision (i) of this subparagraph, if during a 7-year period referred to in such subdivision the taxpayer, directly or indirectly, borrows with respect to more than one annual premium on a contract, such borrowing shall be considered first attributable to the premium for the current policy year (within the meaning of subdivision (iii) of this subparagraph) and then attributable to premiums for prior policy years beginning with the most recent prior policy year (but not including any prior policy year to the extent that such taxpayer has indebtedness outstanding with respect to the premium for such prior policy year). If such borrowing exceeds the premiums paid for the current policy year and for prior policy years and the taxpayer has, with respect to the current policy year, deposited premiums in advance of the due date of such premiums, such excess borrowing shall be considered indebtedness incurred to carry the contract which is attributable to the premiums deposited for succeeding policy years beginning with the premium for the next succeeding policy year. The preceding sentence shall not apply to a single premium contract referred to in §1.264-2.

(iii) Current policy year. For purposes of subdivision (ii) of this subparagraph, the term current policy year refers to the policy year which begins with or within the taxable year of the taxpayer.

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

Example 1. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a policy in the amount of $100,000 with an annual gross premium of $2,200. For the first four policy years, A initially pays the annual premium of $2,200. On January 1, 1965, A deposits an amount equal to the second and third annual premiums, all such amounts initially being paid or deposited by means other than borrowing. On January 1, 1966, pursuant to a plan referred to in paragraph (a) of this section, A borrows $10,000 with respect to the policy. Such borrowing is considered first attributable to paying the premium for the year 1965 and then attributable to paying the premiums for the years 1967, 1966, 1965, and 1964 (in part). No deduction is allowed for the interest paid by A on the $10,000 indebtedness during the year 1965.

Example 2. The facts are the same as in Example 1, except that on January 1, 1964, A pays the first annual premium and deposits an amount equal to the second and third annual premiums, all such amounts initially being paid or deposited by means other than borrowing. On January 1, 1965, A deposits an amount equal to the fourth, fifth, and sixth
annual premiums, and borrows $4,400 pursuant to a plan referred to in paragraph (a) of this section. Such borrowing is considered attributable to the premiums paid for the policy years 1965 and 1964. On January 1, 1966, A deposits an amount equal to the seventh, eighth, and ninth annual premiums, and borrows $6,600 pursuant to such plan. Such borrowing is considered attributable to the premium paid for the policy year 1966 and deposited for the policy years 1967 and 1968. No deduction is allowed for interest paid by A on the $1,000 indebtedness during 1966. Moreover, the interest deduction will be disallowed for the taxable year 1965. However, if this contract is treated as a single premium contract under §1.264–2 (by reason of deposit with the insurer of an amount for payment of a substantial number of future premiums), the deduction for interest on indebtedness incurred or continued to purchase or carry the contract would be denied without reference to this section.

(2) The $100 exception. The total amount paid or accrued during the taxable year by the taxpayer who has entered one or more plans referred to in paragraph (a) of this section for which (without regard to this subparagraph) no deduction would be allowable under paragraph (a) of this section does not exceed $100. Where the amount so paid or accrued during the taxable year exceeds $100, the entire amount shall be subject to the general rule of paragraph (a) of this section.

(3) The unforeseen events exception. The amount is paid or accrued by the taxpayer on indebtedness incurred because of an unforeseen substantial loss of such taxpayer’s income or an unforeseen substantial increase in such taxpayer’s financial obligations. A loss of income or increase in financial obligations is not unforeseen, within the meaning of this subparagraph, if at the time of the purchase of the contract such event was or could have been foreseen. College education expenses are foreseeable; however, if college expenses substantially increase, then to the extent that such increases are unforeseen, this exception will apply. This exception applies only if the plan referred to in paragraph (a) of this section arises because of the unforeseen event. Thus, for example, if a taxpayer or his family incur substantial unexpected medical expenses or the taxpayer is laid off from his job, and for that reason systematically borrows against the cash value of a previously purchased contract, the deduction for the interest paid on the loan will not be denied, whether or not the loan is used to pay a premium on the contract.

(4) The trade or business exception. The indebtedness is incurred by the taxpayer in connection with his trade or business. To be within this exception, the indebtedness must be incurred to finance business obligations rather than to finance cash value life insurance. Thus, if a taxpayer pledges a life insurance, endowment, or annuity contract as part of the collateral for a loan to finance the expansion of inventory or capital improvements for his business, no part of the deduction for interest on such loan will be denied under paragraph (a) of this section. Borrowing by a business taxpayer to finance business life insurance such as under so-called keyman, split dollar, or stock retirement plans is not considered to be incurred in connection with the taxpayer’s trade or business within the meaning of this exception, rather than to finance cash value life insurance shall be made on the basis of all the facts and circumstances. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation M each year borrows substantial sums to carry on its business. Corporation M agrees to provide a retirement plan for its employees and purchases level premium life insurance to fund its obligation under the plan. The mere fact that M Corporation purchases a cash value life insurance policy will not cause its deduction for interest paid on its normal indebtedness to be denied even though the policy is later used as part of the collateral for its normal indebtedness.

Example 2. Corporation R has $200,000 of bonds outstanding and purchases cash value life insurance policies on several of its key employees. Such purchase by R Corporation will not, of itself, cause its deduction for interest on its bonded indebtedness to be denied. If, however, the premiums on the life insurance policies are $10,000 each year, the cash value increases by $6,000 each year, and R Corporation increases its indebtedness by $10,000 each year, its deduction for interest on such indebtedness will not be allowed under the rule of paragraph (a) of this section. On the other hand, the absence of such
a directly parallel increase will not of itself establish that the deduction for interest is allowable.

(e) Applicability of section. The rules of this section apply with respect to taxable years beginning after December 31, 1963, but only with respect to contracts purchased after August 6, 1963. With respect to contracts entered into on or before August 6, 1963, but purchased or acquired whether from the insurer, insured, or any other person (other than by gift, bequest, or inheritance, or in a transaction to which section 381(a) of the Code applies) after such date, the rules of this section apply after such purchase or acquisition.

[T.D. 6773, 29 FR 15751, Nov. 24, 1964]

§ 1.265–1 Expenses relating to tax-exempt income.

(a) Nondeductibility of expenses allocable to exempt income. (1) No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.

(2) No amount shall be allowed as a deduction under section 212 (relating to expenses for production of income) for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt interest income.

(b) Exempt income and nonexempt income. (1) As used in this section, the term class of exempt income means any class of income (whether or not any amount of income of such class is received or accrued) wholly exempt from the taxes imposed by Subtitle A of the Code. For purposes of this section, a class of income which is considered as wholly exempt from the taxes imposed by Subtitle A includes any class of income which is:

(i) Wholly excluded from gross income under any provision of Subtitle A, or

(ii) Wholly exempt from the taxes imposed by Subtitle A under the provisions of any other law.

(2) As used in this section the term nonexempt income means any income which is required to be included in gross income.

(c) Allocation of expenses to a class or classes of exempt income. Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an amount or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(d) Statement of classes of exempt income; records. (1) A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (i) the amount of each class of exempt income, and (ii) the amount of expenses and amounts otherwise allowable allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (c) of this section. If an item is apportioned between a class of exempt income and a class of nonexempt income, the statement shall show the basis of the apportionment. Such statement shall also recite that each deduction claimed in the return is not in any way attributable to a class of exempt income.

(2) The taxpayer shall keep such records as will enable him to make the allocations required by this section. See section 6001 and the regulations thereunder.

§ 1.265–2 Interest relating to tax-exempt income.

(a) In general. No amount shall be allowed as a deduction for interest on any indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from tax under Subtitle A of the Code, such as municipal bonds, Panama Canal loan 3-percent bonds, or obligations of the United States, the interest on which is wholly exempt from tax under Subtitle A, and which were
issued after September 24, 1917, and not originally subscribed for by the taxpayer. Interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry (1) obligations of the United States issued after September 24, 1917, the interest on which is not wholly exempt from the taxes imposed under Subtitle A of the Code, or (2) obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer, the interest on which is wholly exempt from the taxes imposed by Subtitle A of the Code, is deductible. For rules as to the inclusion in gross income of interest on certain governmental obligations, see section 103 and the regulations thereunder.

(b) Special rule for certain financial institutions. (1) No deduction shall be disallowed, for taxable years ending after February 26, 1964, under section 265(2) for interest paid or accrued by a financial institution which is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and which is subject to the banking laws of the State in which it is incorporated, on face-amount certificates (as defined in section 2(a)(15) of the Investment Company Act of 1940) issued by such institution and on amounts received for the purchase of such certificates to be issued by the institution, if the average amount of obligations, the interest on which is wholly exempt from the taxes imposed by Subtitle A of the Code, held by such institution during the taxable year, does not exceed 15 percent of the average amount of total assets of such institution during such year. See subparagraph (3) of this paragraph for treatment of interest paid or accrued on face-amount certificates where the figure is in excess of 15 percent. Interest expense other than that paid or accrued on face-amount certificates or on amounts received for the purchase of such certificates does not come within the rules of this paragraph.

(2) This subparagraph is prescribed under the authority granted the Secretary or his delegate under section 265(2) to prescribe regulations governing the determination of the average amount of tax-exempt obligations and of the total assets held during an institution’s taxable year. The average amount of tax-exempt obligations held during an institution’s taxable year shall be the average of the amounts of tax-exempt obligations held at the end of each month ending within such taxable year. The average amount of total assets for a taxable year shall be the average of the total assets determined at the beginning and end of the institution’s taxable year. If the Commissioner, however, determines that any such amount is not fairly representative of the average amount of tax-exempt obligations or total assets, as the case may be, held by such institution during such taxable year, then the Commissioner shall determine the amount which is fairly representative of the average amount of tax-exempt obligations or total assets, as the case may be. The percentage which the average amount of tax-exempt obligations is of the average amount of total assets is determined by dividing the average amount of tax-exempt obligations by the average amount of total assets, and multiplying by 100. The amount of tax-exempt obligations means that portion of the total assets of the institution which consists of obligations the interest on which is wholly exempt from tax under Subtitle A of the Code, and valued at their adjusted basis, appropriately adjusted for amortization of premium or discount. Total assets means the sum of the money, plus the aggregate of the adjusted basis of the property other than money held by the taxpayer in good faith for the purpose of the business. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes.

(3) If the percentage computation required by subparagraph (2) of this paragraph results in a figure in excess of 15 percent for the taxable year, there is interest that does not come within the special rule for certain financial institutions contained in section 265(2). The amount of such interest is obtained by multiplying the total interest paid or accrued for the taxable year on face-amount certificates and on amounts received for the purchase of such certificates by the percentage figure equal to
the excess of the percentage figure computed under subparagraph (2) of this paragraph over 15 percent. See paragraph (a) for the disallowance of interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax under Subtitle A of the Code.

(4) Every financial institution claiming the benefits of the special rule for certain financial institutions contained in section 265(2) shall file with its return for the taxable year:

(i) A statement showing that it is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and that it is subject to the banking laws of the State in which it is incorporated.

(ii) A detailed schedule showing the computation of the average amount of tax-exempt obligations, the average amount of total assets of such institutions, and the total amount of interest paid or accrued on face-amount certificates and on amounts received for the purchase of such certificates for the taxable year.


§ 1.265–3 Nondeductibility of interest relating to exempt-interest dividends.

(a) In general. No deduction is allowed to a shareholder of a regulated investment company for interest on indebtedness that relates to exempt-interest dividends distributed by the company to the shareholder during the shareholder’s taxable year.

(b) Interest relating to exempt-interest dividends. (1) All or a portion of the interest on an indebtedness relates to exempt-interest dividends if the indebtedness is either incurred or continued to purchase or carry shares of stock of a regulated investment company that distributes exempt-interest dividends (as defined in section 852(b)(5) of the Code) to the holder of the shares during the shareholder’s taxable year.

(2) To determine the amount of interest that relates to the exempt-interest dividends the total amount of interest paid or accrued on the indebtedness is multiplied by a fraction. The numerator of the fraction is the amount of exempt-interest dividends received by the shareholder. The denominator of the fraction is the sum of the exempt-interest dividends and taxable dividends received by the shareholder (excluding capital gain dividends received by the shareholder and capital gains required to be included in the shareholder’s computation of long-term capital gains under section 852(b)(3)(D)).

[T.D. 7601, 44 FR 16013, Mar. 16, 1979]

§ 1.266–1 Taxes and carrying charges chargeable to capital account and treated as capital items.

(a)(1) In general. In accordance with section 266, items enumerated in paragraph (b)(1) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property of the type described in this section are chargeable to capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of Subtitle A of the Code. No deduction is allowable for any items so treated.

(2) See §§1.263A–8 through 1.263A–15 for rules regarding the requirement to capitalize interest, that apply prior to the application of this section. After applying §§1.263A–8 through 1.263A–15, a taxpayer may elect to capitalize interest under section 266 with respect to designated property within the meaning of §1.263A–8(b), provided a computation under any provision of the Internal Revenue Code is not thereby materially distorted, including computations relating to the source of deductions.

(b) Taxes and carrying charges. (1) The taxpayer may elect, as provided in paragraph (c) of this section, to treat the items enumerated in this subparagraph which are otherwise expressly deductible under the provisions of Subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1). The items thus chargeable to capital account are:

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.
(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive:

(a) Interest on a loan (but not theoretical interest of a taxpayer using his own funds),
(b) Taxes of the owner of such real property measured by compensation paid to his employees,
(c) Taxes of such owner imposed on the purchase of materials, or on the storage, use, or other consumption of materials, and
(d) Other necessary expenditures, paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed. The development or construction work with respect to which such items are incurred may relate to unimproved and unproductive real estate whether the construction work will make the property productive of income subject to tax (as in the case of a factory) or not (as in the case of a personal residence), or may relate to property already improved or productive (as in the case of a plant addition or improvement, such as the construction of another floor on a factory or the installation of insulation therein).

(iii) In the case of personal property:

(a) Taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein.
(b) Interest on a loan to purchase such property or to pay for transporting or installing the same, and
(c) Taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

(iv) Any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.

(2) The sole effect of section 266 is to permit the items enumerated in subparagraph (1) of this paragraph to be chargeable to capital account notwithstanding that such items are otherwise expressly deductible under the provisions of Subtitle A of the Code. An item not otherwise deductible may not be capitalized under section 266.

(3) In the absence of a provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of this section, and items which are otherwise treated as capital items are to be so treated. Similarly, an item not otherwise deductible is not made deductible by this section. Nor is the absence of a provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item.

(c) Election to charge taxes and carrying charges to capital account.

(1) If for any taxable year there are two or more items of the type described in paragraph (b)(1) of this section, which relate to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if expenditures for several items of the same type are incurred with respect to a single project, the election to capitalize must, if exercised, be exercised as to all items of that type. For purposes of this section, a project means, in the case of items described in paragraph (b)(1)(i) of this section, a particular development of, or construction of an improvement to, real property, and in the case of items described in paragraph (b)(1)(ii) of this section, the transportation and installation of machinery or other fixed assets.

(2)(i) An election with respect to an item described in paragraph (b)(1)(i) of this section is effective only for the year for which it is made.
(i) An election with respect to an item described in:  
(a) Paragraph (b)(1)(i) of this section is effective until the development or construction work described in that subdivision has been completed;  
(b) Paragraph (b)(1)(ii) of this section is effective until the later of either the date of installation of the property described in that subdivision, or the date when such property is first put into use by the taxpayer;  
(c) Paragraph (b)(1)(iv) of this section is effective as determined by the Commissioner.  
Thus, an item chargeable to capital account under this section must continue to be capitalized for the entire period described in this subdivision applicable to such election although such period may consist of more than one taxable year;  
(3) If the taxpayer elects to capitalize an item or items under this section, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items (whether with respect to the same project or to different projects) which the taxpayer elects to treat as chargeable to capital account. Elections filed for taxable years beginning before January 1, 1955, and for taxable years ending before August 17, 1954, under section 24(a)(7) of the Internal Revenue Code of 1939, and the regulations thereunder, shall have the same effect as if they were filed under this section. See section 7807(b)(2).  
(d) The following examples are illustrative of the application of the provisions of this section:  

Example 1. In 1956 and 1957 A pays annual taxes and interest on a mortgage on a piece of real property. During 1956, the property is vacant and unproductive, but throughout 1957 A operates the property as a parking lot. A may capitalize the taxes and mortgage interest paid in 1956, but not the taxes and mortgage interest paid in 1957.  

Example 2. In February 1957, B began the erection of an office building for himself. B in 1957, in connection with the erection of the building, paid $8,000 social security taxes, which in his 1957 return he elected to capitalize. B must continue to capitalize the social security taxes paid in connection with the erection of the building until its completion.  

Example 3. Assume the same facts as in Example 2 except that in November 1957, B also begins to build a hotel. In 1957 B pays $3,000 social security taxes in connection with the erection of the hotel. B's election to capitalize the social security taxes paid in erecting the office building started in February 1957 does not bind him to capitalize the social security taxes paid in erecting the hotel; he may deduct the $3,000 social security taxes paid in erecting the hotel.  

Example 4. In 1957, M Corporation began the erection of a building for itself, which will take three years to complete. M Corporation in 1957 paid $4,000 social security taxes and $8,000 interest on a building loan in connection with this building. M Corporation may elect to capitalize the social security taxes although it deducts the interest charges.  

Example 5. C purchases machinery in 1957 for use in his factory. He pays social security taxes on the labor for transportation and installation of the machinery, as well as interest on a loan to obtain funds to pay for the machinery and for transportation and installation costs. C may capitalize either the social security taxes or the interest, or both, up to the date of installation or until the machinery is first put into use by him, whichever date is later.  

(e) Allocation. If any tax or carrying charge with respect to property is in part a type of item described in paragraph (b) of this section and in part a type of item or items with respect to which no election to treat as a capital item is given, a reasonable proportion of such tax or carrying charge, determined in the light of all the facts and circumstances in each case, shall be allocated to each item. The rule of this paragraph may be illustrated by the following example:  

Example. N Corporation, the owner of a factory in New York on which a new addition is under construction, in 1957 pays its general manager, B, a salary of $10,000 and also pays a New York State unemployment insurance tax of $81 on B's salary. B spends nine-tenths of his time in the general business of the firm and the remaining one-tenth in supervising the construction work. N Corporation treats as expenses $9,000 of B's salary, and charges the remaining $1,000 to capital account. N Corporation may elect to capitalize $8,10 of the $81 New York State unemployment insurance tax paid in 1957 since such tax is deductible under section 164.  

§ 1.267(a)–1 Deductions disallowed.

(a) Losses. Except in cases of distributions in corporate liquidations, no deduction shall be allowed for losses arising from direct or indirect sales or exchanges of property between persons who, on the date of the sale or exchange, are within any one of the relationships specified in section 267(b). See §1.267(b)–1.

(b) Unpaid expenses and interest. (1) No deduction shall be allowed a taxpayer for trade or business expenses otherwise deductible under section 162, for expenses for production of income otherwise deductible under section 212, or for interest otherwise deductible under section 163:

(i) If, at the close of the taxpayer’s taxable year within which such items are accrued by the taxpayer or at any time within 2 1/2 months thereafter, both the taxpayer and the payee are persons within any one of the relationships specified in section 267(b) (see §1.267(b)–1); and

(ii) If the payee is on the cash receipts and disbursements method of accounting with respect to such items of gross income for his taxable year in which or with which the taxable year of accrual by the debtor-taxpayer ends; and

(iii) If, within the taxpayer’s taxable year within which such items are accrued by the taxpayer and 2 1/2 months after the close thereof, the amount of such items is not paid and the amount of such items is not otherwise (under the rules of constructive receipt) includible in the gross income of the payee.

(2) The provisions of section 267(a)(2) and this paragraph do not otherwise affect the general rules governing the allowance of deductions under an accrual method of accounting. For example, if the accrued expenses or interest are paid after the deduction has become disallowed under section 267(a)(2), no deduction would be allowable for the taxable year in which payment is made, since an accrual item is deductible only in the taxable year in which it is properly accrualable.

(3) The expenses and interest specified in section 267(a)(2) and this paragraph shall be disallowed for purposes of that section to the extent of the fair market value on the date of issue of notes or other instruments of similar effect received in payment of such expenses or interest if such notes or other instruments were issued in such payment by the taxpayer within his taxable year or within 2 1/2 months after the close thereof. The fair market value on the date of issue of such notes or other instruments of similar effect is includible in the gross income of the payee for the taxable year in which he receives the notes or other instruments.

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

Example. A, an individual, is the holder and owner of an interest-bearing note of the M Corporation, all the stock of which was owned by him on December 31, 1956. A and the M Corporation make their income tax returns for a calendar year. The M Corporation uses an accrual method of accounting. A uses a combination of accounting methods permitted under section 446(c)(4) in which he uses the cash receipts and disbursements method in respect of items of gross income. The M Corporation does not pay any interest on the note to A during the calendar year 1956 or within 2 1/2 months after the close of that year, nor does it credit any interest to A’s account in such a manner that it is subject to his unqualified demand and thus is constructively received by him. M Corporation claims a deduction for the year 1956 for the interest accruing on the note in that year. Since A is on the cash receipts and disbursements method in respect of items of gross income, the interest is not includible in his return for the year 1956. Under the provisions of section 267(a)(2) and this paragraph, no deduction for such interest is allowable in computing the taxable income of the M Corporation for the taxable year 1956 or for any other taxable year. However, if the interest had actually been paid to A on or before March 15, 1957, or if it had been made available to A before that time (and thus had been constructively received by him), the M Corporation would be allowed to deduct the amount of the payment in computing its taxable income for 1956.

(c) Scope of section. Section 267(a) requires that deductions for losses or unpaid expenses or interest described therein be disallowed even though the transaction in which such losses, expenses, or interest were incurred was a bona fide transaction. However, section 267 is not exclusive. No deduction for losses or unpaid expenses or interest
arising in a transaction which is not bona fide will be allowed even though section 267 does not apply to the trans-

§ 1.267(a)–2T Temporary regulations; questions and answers arising under the Tax Reform Act of 1984 (temporary).

(a) Introduction—(1) Scope. This section prescribes temporary question and answer regulations under section 267(a) and related provisions as amended by section 174 of the Tax Reform Act of 1984, Pub. L. No. 98–369.

(2) Effective date. Except as otherwise provided by Answer 2 or Answer 3 in paragraph (c) of this section, the effective date set forth in section 174(c) of the Tax Reform Act of 1984 applies to this section.

(b) Questions applying section 267(a)(2) and (b) generally. The following questions and answers deal with the application of section 267(a)(2) and (b) generally:

Question 1: Does section 267(a)(2) ever apply to defer the deduction of an otherwise deductible amount if the person to whom the payment is to be made properly uses the completed contract method of accounting with respect to such amount?

Answer 1: No. Section 267(a)(2) applies only if an otherwise deductible amount is owed to a related person under whose method of accounting such amount is not includible in income unless paid to such person. Regardless of when payment is made, an amount owed to a contractor using the completed contract method of accounting is includible in the income of the contractor in accordance with §1.451–3(d) in the year in which the contract is completed or in which certain disputes are resolved.

Question 2: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible original issue discount as defined in sections 163(e) and 1271 through 1275 (“the OID rules”)?

Answer 2: No. Regardless of when payment is made, an amount owed to a lender that constitutes original issue discount is included in the income of the lender periodically in accordance with the OID rules. Similarly, section 267(a)(2) does not apply to defer an otherwise deductible amount to the extent section 467 or section 7872 requires periodic inclusion of such amount in the income of the person to whom payment is to be made, even though payment has not been made.

Question 3: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible unstated interest determined to exist under section 483?

Answer 3: Yes. If section 483 recharacterizes any amount as unstated interest and the other requirements of section 267(a)(2) are met, a deduction for such unstated interest will be deferred under section 267.

Question 4: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization?

Answer 4: Yes, in certain cases. In general, section 267(a)(2) does not apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization. Notwithstanding this general rule, if the other requirements of section 267(a)(2) are met, section 267(a)(2) does apply to defer deductions for cost recovery, depreciation, or amortization of an amount owed to a related person for interest or rent or for the performance or nonperformance of services, which amount the taxpayer payor capitalized or treated as a deferred expense (unless the taxpayer payor elected to capitalize or defer the amount and section 267(a)(2) would not have deferred the deduction of such amount if the taxpayer payor had not so elected). Amounts owed for services that may be subject to this provision include, for example, amounts owed for acquisition, development, or organizational services or for covenants not to compete. In applying this rule, payments made between persons described in any of the paragraphs of section 267(b) (as modified by section 267(e)) will be closely scrutinized to determine whether they are made in respect of capitalized costs (or costs treated as deferred expenses) that are subject to deferral under section 267(a)(2), or in respect of other capitalized costs not so subject.

Question 5: If a deduction in respect of an otherwise deductible amount is deferred by section 267(a)(2) and, prior to the time the amount is includible in the gross income of the person to
whom payment is to be made, such person and the payor taxpayer cease to be persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e)), is the deduction allowable as of the day on which the relationship ceases?

Answer 1: No. The deduction is not allowable until the day as of which the amount is includible in the gross income of the person to whom payment of the amount is made, even though the relationship ceases to exist at an earlier time.

Question 6: Do references in other sections to persons described in section 267(b) incorporate changes made to section 267(b) by section 174 of the Tax Reform Act of 1984?

Answer 6: Yes. References in other sections to persons described in section 267(b) take into account changes made to section 267(b) by section 174 of the Tax Reform Act of 1984 (without modification by section 267(e)(1)). For example, a transfer after December 31, 1983 (the effective date of the new section 267(b)(3) relationship added by the Tax Reform Act of 1984) of section 1245 class property placed in service before January 1, 1981, from one corporation to another corporation, 11 percent of the stock of which is owned by the first corporation, will not constitute recovery property (as defined in section 168) in the hands of the second corporation by reason of section 168(e)(4) (A)(1) and (D).

(c) Questions applying section 267(a) to partnerships. The following questions and answers deal with the application of section 267(a) to partnerships:

Question 1: Does section 267(a) disallow losses and defer otherwise deductible amounts at the partnership (entity) level?

Answer 1: Yes. If a loss realized by a partnership from a sale or exchange of property is disallowed under section 267(a)(1), that loss shall not enter into the computation of the partnership’s taxable income. If an amount that otherwise would be deductible by a partnership is deferred by section 267(a)(2), that amount shall not enter into the computation of the partnership’s taxable income until the taxable year of the partnership in which falls the day on which the amount is includible in the gross income of the person to whom payment of the amount is made.

Question 2: Does section 267(a)(1) ever apply to disallow a loss if the sale or exchange giving rise to the loss is between two partnerships even though the two partnerships are not persons specified in any of the paragraphs of section 267(b)?

Answer 2: Yes. If the other requirements of section 267(a)(1) are met, section 267(a)(1) applies to such losses arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) as follows, and §1.267(b)–1(b) does not apply. If the two partnerships have one or more common partners (i.e., if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the selling partnership’s loss will be disallowed under section 267(a)(1). The amount disallowed under this rule is the greater of: (1) The amount that would be disallowed if the transaction giving rise to the loss had occurred between the selling partnership and the separate partners of the purchasing partnership (in proportion to their respective interests in the purchasing partnership); or (2) the amount that would be disallowed if such transaction had occurred between the separate partners of the selling partnership and the separate partners of the purchasing partnership (in proportion to their respective interests in the purchasing partnership); or (2) the amount that would be disallowed if such transaction had occurred between the separate partners of the selling partnership and the separate partners of the purchasing partnership. Notwithstanding the general rule of this paragraph (c) Answer 2, no disallowance shall occur if the amount that would be disallowed pursuant to the immediately preceding sentence is less than 5 percent of the loss arising from the sale or exchange.

Question 3: Does section 267(a)(2) ever apply to defer an otherwise deductible amount if the taxpayer payor is a partnership and the person to whom payment of such amount is to be made is a partnership even though the two partnerships are not persons specified
in any of the paragraphs of section 267(b) (as modified by section 267(e))?

Answer 3: Yes. If the other requirements of section 267(a)(2) are met, section 267(a)(2) applies to such amounts arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) (as modified by section 267(e)) as follows, and §1.267(b)–1(b) does not apply. If the two partnerships have one or more common partners (i.e., if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the payor partnership’s otherwise allowable deduction will be deferred under section 267(a)(2). The amount deferred under this rule is the greater of: (1) The amount that would be deferred if the transaction giving rise to the otherwise allowable deduction had occurred between the payor partnership and the separate partners of the payee partnership (in proportion to their respective interests in the payee partnership); or (2) the amount that would be deferred if such transaction had occurred between the separate partners of the payor partnership (in proportion to their respective interests in the payor partnership) and the payee partnership. Notwithstanding the general rule of this paragraph (c) Answer 3, no deferral shall occur if the amount that would be deferred pursuant to the immediately preceding sentence is less than 5 percent of the otherwise allowable deduction.

Example. On May 1, 1985, partnership AB enters into a transaction whereby it accrues an otherwise deductible amount to partnership AC. AC is on the cash receipts and disbursements method of accounting. A holds a 5 percent capital and profits interest in AB and a 49 percent capital and profits interest in AC, and A’s interest in each item of the income, gain, loss, deduction, and credit of each partnership is 5 percent and 49 percent, respectively. B and C are not related. Notwithstanding that AB and AC are not persons specified in section 267(b), 49 percent of the deduction in respect of such amount will be deferred under section 267(a)(2). The result would be the same if A held a 49 percent interest in AB and a 5 percent interest in AC. However, if A held more than 50 percent of the capital or profits interest of either AB or AC, the entire deduction in respect of such amount would be deferred under section 267(a)(2).

Question 4: What does the phrase incurred at an annual rate not in excess of 12 percent mean as used in section 267(e)(5)(C)(ii)?

Answer 4: The phrase refers to interest that accrues but is not includible in the income of the person to whom payment is to be made during the taxable year of the payor. Thus, in determining whether the requirements of section 267(e)(5) (providing an exception to certain provisions of section 267 for certain expenses and interest of partnerships owning low income housing) are met with respect to a transaction, the requirement of section 267(e)(5)(C)(ii) will be satisfied, even though the total interest (both stated and unstated) paid or accrued in any taxable year of the payor taxpayer exceeds 12 percent, if the interest in excess of 12 percent per annum, compounded semi-annually, on the outstanding loan balance (principal and accrued but unpaid interest) is includible in the income of the person to whom payment is to be made no later than the last day of such taxable year of the payor taxpayer.

§1.267(a)–3 Deduction of amounts owed to related foreign persons.

(a) Purpose and scope. This section provides rules under section 267(a)(2) and (3) governing when an amount owed to a related foreign person that is otherwise deductible under Chapter 1 may be deducted. Paragraph (b) of this section provides the general rules, and paragraph (c) of this section provides exceptions and special rules.

(b) Deduction of amount owed to related foreign person—(1) In general. Except as provided in paragraph (c) of this section, section 267(a)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign
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person. An amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 thus may not be deducted by the taxpayer until such amount is paid to the related foreign person. For purposes of this section, a related foreign person is any person that is not a United States person within the meaning of section 7701(a)(30), and that is related (within the meaning of section 267(b)) to the taxpayer at the close of the taxable year in which the amount incurred by the taxpayer would otherwise be deductible. Section 267(f) defines controlled group for purposes of section 267(b) without regard to the limitations of section 1563(b). An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 884(f)).

(2) Amounts covered. This section applies to otherwise deductible amounts that are of a type described in section 871(a)(1) (A), (B) or (D), or in section 881(a)(1), (2) or (4). The rules of this section also apply to interest that is from sources outside the United States. Amounts other than interest that are from sources outside the United States, and that are not income of a related foreign person effectively connected with the conduct by such related foreign person of a trade or business within the United States, are not subject to the rules of section 267(a)(2) or (3) or this section. See paragraph (c) of this section for rules governing the treatment of amounts that are income of a related foreign person effectively connected with the conduct of a trade or business within the United States by such related foreign person.

(3) Change in method of accounting. A taxpayer that uses a method of accounting other than that required by the rules of this section must change its method of accounting to conform its method to the rules of this section. The taxpayer’s change in method must be made pursuant to the rules of section 446(e), the regulations thereunder, and any applicable administrative procedures prescribed by the Commissioner. Because the rules of this section prescribe a method of accounting, these rules apply in the determination of taxpayer’s earnings and profits pursuant to §1.1312–6(a).

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

Example 1. (i) FC, a corporation incorporated in Country X, owns 100 percent of the stock of C, a domestic corporation. C uses the accrual method of accounting in computing its income and deductions, and is a calendar year taxpayer. In Year 1, C accrues an amount owed to FC for interest. C makes an actual payment of the amount owed to FC in Year 2.

(ii) Regardless of its source, the interest owed to FC is an amount to which this section applies. Pursuant to the rules of this paragraph (b), the amount owed to FC by C will not be allowable as a deduction in Year 1. Section 267 does not preclude the deduction of this amount in Year 2.

Example 2. (i) RS, a domestic corporation, is the sole shareholder of FSC, a foreign sales corporation. Both RS and FSC use the accrual method of accounting. In Year 1, RS accrues $x owed to FSC for commissions earned by FSC in Year 1. Pursuant to the foreign sales company provisions, sections 921 through 927, a portion of this amount, $y, is treated as effectively connected income of FSC from sources outside the United States. Accordingly, the rules of section 267(a)(3) and paragraph (b) of this section do not apply. See paragraph (c) of this section for the rules governing the treatment of amounts that are effectively connected income of FSC.

(ii) The remaining amount of the commission, $z, is classified as exempt foreign trade income under section 923(a)(3) and is treated as effectively connected income of FSC from sources outside the United States. This amount is one to which the provisions of this section do not apply, since it is an amount other than interest from sources outside the United States and is not effectively connected income. Therefore, a deduction for $y is allowable to RS as of the day on which it accrues the otherwise deductible amount, without regard to section 267 (a)(2) and (a)(3) and the regulations thereunder.

(c) Exceptions and special rules—(1) Effectively connected income subject to United States tax. The provisions of section 267(a)(2) and the regulations thereunder, and not the provisions of paragraph (b) of this section, apply to an amount that is income of the related foreign person that is effectively connected with the conduct of a United States trade or business of such related foreign person. An amount described in this paragraph (c)(1) thus is allowable
as a deduction as of the day on which the amount is includible in the gross income of the related foreign person as effectively connected income under sections 872(a)(2) or 882(b) (or, if later, as of the day on which the deduction would be so allowable but for section 267(a)(2)). However, this paragraph (c)(1) does not apply if the related foreign person is exempt from United States income tax on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits).

(2) Items exempt from tax by treaty. Except with respect to interest, neither paragraph (b) of this section nor section 267(a)(2) or (a)(3) applies to any amount that is income of a related foreign person with respect to which the related foreign person is exempt from United States taxation on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the United States. Interest that is effectively connected income of the related foreign person under sections 872(a)(2) or 882(b) is an amount covered by paragraph (c)(1) of this section. Interest that is not effectively connected income of the related foreign person is an amount covered by paragraph (b) of this section, regardless of whether the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United States.

(3) Items subject to reduced rate of tax by treaty. Paragraph (b) of this section applies to amounts that are income of a related foreign person with respect to which the related foreign person claims a reduced rate of United States income tax on the amount owed pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits).

(4) Amounts owed to a foreign personal holding company, controlled foreign corporation, or passive foreign investment company—(i) Foreign personal holding companies. If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a foreign personal holding company within the meaning of section 552, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the foreign personal holding company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the foreign personal holding company computes its taxable income and earnings and profits for purposes of sections 551 through 558. See section 551(c) and the regulations thereunder for the reporting requirements of the foreign personal holding company provisions (sections 551 through 558).

(ii) Controlled foreign corporations. If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a controlled foreign corporation within the meaning of section 957, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the controlled foreign corporation. The day on which the amount is includible in income is determined with reference to the method of accounting under which the controlled foreign corporation computes its taxable income and earnings and profits for purposes of sections 951 through 964. See section 6038 and the regulations thereunder for the reporting requirements of the controlled foreign corporation provisions (sections 951 through 964).

(iii) Passive foreign investment companies. If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a passive foreign investment company within the meaning of section 1296, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the passive foreign investment company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the earnings and profits of the passive foreign investment company are computed for purposes of sections 1291 through 1297. See sections 1291 through 1297 and the regulations thereunder for the reporting requirements of the passive foreign investment company provisions. This exception shall apply, however, only if the person that
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owes the amount at issue has made and has in effect an election pursuant to section 1295 with respect to the passive foreign investment company to which the amount at issue is owed.

(iv) Examples. The rules of this paragraph (c)(4) may be illustrated by the following examples. Application of the provisions of sections 951 through 964 are provided for illustration only, and do not provide substantive rules concerning the operation of those provisions. The principles of these examples apply equally to the provisions of paragraphs (c)(4) (i) through (iii) of this section.

Example 1. P, a domestic corporation, owns 100 percent of the total combined voting power and value of the stock of both FC1 and FC2. P is a calendar year taxpayer that uses the accrual method of accounting in computing its income and deductions. FC1 is incorporated in Country X, and FC2 are controlled foreign corporations within the meaning of section 957, and are both calendar year taxpayers. FC1 computes its taxable income and earnings and profits, for purposes of sections 951 through 964, using the accrual method of accounting, while FC2 uses the cash method. In Year 1 FC1 has gross income of $10,000 that is described in section 952 (a) ("subpart F income"), which includes interest owed to FC1 by P that is described in paragraph (b) of this section and that is otherwise allowable as a deduction to P under chapter 1. The interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 2. The facts are the same as in Example 1, except that in Year 1 FC1 reports no subpart F income because of the application of section 954 (b)(3)(A) (the subpart F de minimis rule). Because the amount owed to FC1 by P is includible in FC1’s gross income in Year 1, the interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 3. The facts are the same as in Example 1. In Year 1, FC1 accrues interest owed to FC2 that would be allowable as a deduction by FC1 under chapter 1 if FC1 were a domestic corporation. The interest owed to FC2 by FC1 is paid by FC1 in Year 2. Because FC2 uses the cash method of accounting in computing its taxable income for purposes of subpart F, the interest owed by FC1 is allowable as a deduction by FC1 in Year 2, and not in Year 1.

(d) Effective date. The rules of this section are effective with respect to interest that is allowable as a deduction under chapter 1 (without regard to the rules of this section) in taxable years beginning after December 31, 1983, but are not effective with respect to interest that is incurred with respect to indebtedness incurred on or before September 29, 1983, or incurred after that date pursuant to a contract that was binding on that date and at all times thereafter (unless the indebtedness or the contract was renegotiated, extended, renewed, or revised after that date). The regulations in this section issued under section 267 apply to all other deductible amounts that are incurred after July 31, 1989, but do not apply to amounts that are included pursuant to a contract that was binding on September 29, 1983, and at all times thereafter (unless the contract was renegotiated, extended, renewed, or revised after that date).

[T.D. 8465, 58 FR 237, Jan. 5, 1993]

§ 1.267(b)–1 Relationships.

(a) In general. (1) The persons referred to in section 267(a) and §1.267(a)–1 are specified in section 267(b).

(2) Under section 267(b)(3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.

(3) Under section 267(b)(9), the control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable. In the case of an individual, control possessed by the individual’s family, as defined in section 267(c)(4) and paragraph (a)(4) of §1.267(c)–1, shall be taken into account.

(b) Partnerships. (1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within
the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and §1.707–1. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed:

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner’s distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

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

Example 1. A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2 1/2 months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation’s deduction for the accrued interest is not allowed to the extent of A’s distributive share (one-third) of such interest income. M Corporation’s deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A’s one-third interest in the purchased property.

§1.267(c)–1 Constructive ownership of stock.

(a) In general. (1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner’s distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

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

Example 1. A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2 1/2 months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation’s deduction for the accrued interest is not allowed to the extent of A’s distributive share (one-third) of such interest income. M Corporation’s deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A’s one-third interest in the purchased property.

§1.267(c)–1 Constructive ownership of stock.

(a) In general. (1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner’s distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

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

Example 1. A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2 1/2 months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation’s deduction for the accrued interest is not allowed to the extent of A’s distributive share (one-third) of such interest income. M Corporation’s deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A’s one-third interest in the purchased property.
constructive ownership, under section 267(c)(1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as actual ownership of the stock, and the individual’s ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term ancestors includes parents and grandparents, and the term lineal descendants includes children and grandchildren.

(b) Examples. The application of section 267(c) may be illustrated by the following examples:

   Example 1. On July 1, 1957, A owned 75 percent, and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267(c)(1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock. Therefore, A constructively owns 60 percent (75 percent of 80 percent) of the O Corporation stock and AW constructively owns 20 percent (25 percent of 80 percent) of such stock. Under the family ownership rule of section 267(c)(2), an individual is considered as constructively owning the stock actually owned by his spouse. A and AW, therefore, are each considered as constructively owning the M Corporation stock actually owned by the other. For the purpose of applying this family ownership rule, A’s and AW’s constructive ownership of O Corporation stock is considered as actual ownership under section 267(c)(5). Thus, A constructively owns the 20 percent of the O Corporation stock constructively owned by AW, and AW constructively owns the 60 percent of the O Corporation stock constructively owned by A. In addition, the family ownership rule may be applied to make AWF, AW’s father, the constructive owner of the 25 percent of the M Corporation stock actually owned by AW. As noted above, AW’s constructive ownership of 20 percent of the O Corporation stock is considered as actual ownership for purposes of applying the family ownership rule, and AWF is thereby considered the constructive owner of this stock also. However, AW’s constructive ownership of the stock constructively and actually owned by A may not be considered as actual ownership for the purpose of again applying the family ownership rule to make AWF the constructive owner of these shares. The ownership of the stock in the M and O Corporations may be tabulated as follows:

<table>
<thead>
<tr>
<th>Person</th>
<th>Stock ownership in M Corporation</th>
<th>Total under Section 267 (Percent)</th>
<th>Stock ownership in O Corporation</th>
<th>Total under Section 267 (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual (Percent)</td>
<td>Constructive (Percent)</td>
<td>Actual (Percent)</td>
<td>Constructive (Percent)</td>
</tr>
<tr>
<td>A</td>
<td>75 25</td>
<td>100 None 60 80</td>
<td>A W (A’s wife)</td>
<td>25 75</td>
</tr>
<tr>
<td>M Corporation</td>
<td>None</td>
<td>None</td>
<td>O Corporation</td>
<td>None</td>
</tr>
</tbody>
</table>

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that other corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm’s length sale or exchange between A and AW, and between AWF and the M or O Corporation.

Example 2. On June 15, 1957, all of the stock of the N Corporation was owned in equal proportions by A and his partner, AP. Except in the case of distributions in liquidation by the M Corporation, a constructive owner of the stock in the M and O Corporations may be tabulated as follows:

<table>
<thead>
<tr>
<th>Person</th>
<th>Stock ownership in M Corporation</th>
<th>Total under Section 267 (Percent)</th>
<th>Stock ownership in O Corporation</th>
<th>Total under Section 267 (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual (Percent)</td>
<td>Constructive (Percent)</td>
<td>Actual (Percent)</td>
<td>Constructive (Percent)</td>
</tr>
<tr>
<td>A</td>
<td>75 25</td>
<td>100 None 60 80</td>
<td>A W (A’s wife)</td>
<td>25 75</td>
</tr>
<tr>
<td>M Corporation</td>
<td>None</td>
<td>None</td>
<td>O Corporation</td>
<td>None</td>
</tr>
</tbody>
</table>

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that other corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm’s length sale or exchange between A and AWF, and between AWF and the M or O Corporation.
§ 1.267(d)-1 Amount of gain where loss previously disallowed.

(a) General rule. (1) If a taxpayer acquires property by purchase or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of section 267(a)(1) or by reason of section 24(b) of the Internal Revenue Code of 1939, then any gain realized by the taxpayer on a sale or other disposition of the property after December 31, 1953, shall be recognized only to the extent that the gain exceeds the amount of such loss, and if the original property was acquired in a transaction in which a loss to a transferor was not allowable by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939).

(3) The benefit of the general rule is available only to the original transferee but does not apply to any original transferee (e.g., a donee) who acquired the property in any manner other than by purchase or exchange.

(b) Determination of basis and gain with respect to divisible property—(1)


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Taxpayer’s basis. When the taxpayer acquires divisible property or property that consists of several items or classes of items by a purchase or exchange on which loss is not allowable to the transferor, the basis in the taxpayer’s hands of a particular part, item, or class of such property shall be determined (if the taxpayer’s basis for that part is not known) by allocating to the particular part, item, or class a portion of the taxpayer’s basis for the entire property in the proportion that the fair market value of the particular part, item, or class bears to the fair market value of the entire property at the time of the taxpayer’s acquisition of the property.

(2) Taxpayer’s recognized gain. Gain realized by the taxpayer on sales or other dispositions after December 31, 1953, of a part, item, or class of the property shall be recognized only to the extent that such gain exceeds the amount of loss attributable to such part, item, or class bears to the fair market value of the entire property at the time of the taxpayer’s acquisition of the property.

(3) Transferor’s loss not allowable. (1) The transferor’s loss on the sale or exchange of a part, item, or class of the property to the taxpayer shall be the excess of the transferor’s adjusted basis for determining loss on the part, item, or class of the property over the amount realized by the transferor on the sale or exchange of the part, item, or class. The amount realized by the transferor on the part, item, or class shall be determined (if such amount is not known) in the same manner that the taxpayer’s basis for such part, item, or class is determined. See subparagraph (1) of this paragraph.

(ii) If the transferor’s basis for determining loss on the part, item, or class cannot be determined, the transferor’s loss on the particular part, item, or class transferred to the taxpayer shall be determined by allocating to the part, item, or class a portion of his loss on the entire property in the proportion that the fair market value of such part, item, or class bears to the fair market value of the entire property on the date of the taxpayer’s acquisition of the entire property.

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

Example 1. During 1953, H sold class A stock which had cost him $1,100, and common stock which had cost him $2,000, to his wife W for a lump sum of $1,500. Under section 24(b)(1)(A) of the 1939 Code, the loss of $1,600 on the transaction was not allowable to H. At the time the stocks were purchased by W, the fair market value of class A stock was $900 and the fair market value of common stock was $600. In 1954, W sold the class A stock for $2,500. W’s recognized gain is determined as follows:

\[
\text{Recognized gain on sale of class A stock by W} = 1,400
\]


Example 2. Assume the same facts as those stated in Example 1 of this subparagraph except that H originally purchased both classes of stock for a lump sum of $3,100. The unallowable loss to H on sale of all the stock to W is $1,600 ($3,100 minus $1,500). An exact determination of the unallowable loss sustained by H on sale of class A stock cannot be made because H’s basis for class A stock cannot be determined. Therefore, a determination of the unallowable loss is made by allocating to class A stock a portion of H’s loss on the entire property transferred to W in the proportion that the fair market value of class A stock at the time acquired by W ($900) bears to the fair market value of both classes of stock at that time ($3,100).

\[
\text{Recognized gain on sale of class A stock by W} = 1,400
\]

(c) Special rules. (1) Section 267(d) does not affect the basis of property for determining gain. Depreciation and other items which depend on such basis are also not affected.

(2) The provisions of section 267(d) shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091, or section 118 of the Internal Revenue Code of 1939, which relate to losses from wash sales of stock or securities.

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In determining the holding period in the hands of the transferee of property received in an exchange with a transferor with respect to whom a loss on the exchange is not allowable by reason of section 267, section 1223(2) does not apply to include the period during which the property was held by the transferor. In determining such holding period, however, section 1223(1) may apply to include the period during which the transferee held the property which he exchanged where, for example, he exchanged a capital asset in a transaction which, as to him, was nontaxable under section 1031 and the property received in the exchange has the same basis as the property exchanged.

§ 1.267(d)–2 Effective date; taxable years subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.267(d)–1, to the extent that they relate to determination of gain resulting from the sale or other disposition of property after December 31, 1953, with respect to which property a loss was not allowable to the transferor by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939), shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and taxable years beginning after December 31, 1953, and ending before August 17, 1954, which years are subject to the Internal Revenue Code of 1939.

§ 1.267(f)–1 Controlled groups.

(a) In general—(1) Purpose. This section provides rules under section 267(f) to defer losses and deductions from certain transactions between members of a controlled group (intercompany sales). The purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer of property between a selling member (S) and a buying member (B).

(2) Application of consolidated return principles. Under this section, S’s loss or deduction from an intercompany sale is taken into account under the timing principles of §1.1502-13 (intercompany transactions between members of a consolidated group), treating the intercompany sale as an intercompany transaction. For this purpose:

(i) The matching and acceleration rules of §1.1502-13 (c) and (d), the definitions and operating rules of §1.1502-13 (b) and (j), and the simplifying rules of §1.1502-13(e)(1) apply with the adjustments in paragraphs (b) and (c) of this section to reflect that this section—

(A) Applies on a controlled group basis rather than consolidated group basis; and

(B) Generally affects only the timing of a loss or deduction, and not its attributes (e.g., its source and character) or the holding period of property.

(ii) The special rules under §1.1502-13(f) (stock of members) and (g) (obligations of members) apply under this section only to the extent the transaction is also an intercompany transaction to which §1.1502-13 applies.

(iii) Any election under §1.1502-13 to take items into account on a separate entity basis does not apply under this section. See §1.1502-13(e)(3).

(b) Definitions and operating rules. The definitions in §1.1502-13(b) and the operating rules of §1.1502-13(j) apply under this section with appropriate adjustments, including the following:

(1) Intercompany sale. An intercompany sale is a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of §1.1502-13, determined by
treated the references to a consolidated group as references to a controlled group and by disregarding whether any of the members join in filing consolidated returns.

(2) S’s losses or deductions. Except to the extent the intercompany sale is also an intercompany transaction to which §1.1502–13 applies, S’s losses or deductions subject to this section are determined on a separate entity basis. For example, the principles of §1.1502–13(b)(2)(iii) (treating certain amounts not yet recognized as items to be taken into account) do not apply. A loss or deduction is from an intercompany sale whether it is directly or indirectly from the intercompany sale.

(3) Controlled group; member. For purposes of this section, a controlled group is defined in section 267(f). Thus, a controlled group includes a FSC (as defined in section 922) and excluded members under section 1563(b)(2), but does not include a DISC (as defined in section 992). Corporations remain members of a controlled group as long as they remain in a controlled group relationship with each other. For example, corporations become nonmembers with respect to each other when they cease to be in a controlled group relationship with each other, rather than by having a separate return year (described in §1.1502–13(j)(7)). Further, the principles of §1.1502–13(j)(6) (former common parent treated as continuation of group) apply to any corporation if, immediately before it becomes a nonmember, it is both the selling member and the owner of property with respect to which a loss or deduction is deferred (whether or not it becomes a member of a different controlled group filing consolidated or separate returns). Thus, for example, if S and B merge together in a transaction described in section 368(a)(1)(A), the surviving corporation is treated as the successor to the other corporation, and the controlled group relationship is treated as continuing.

(4) Consolidated taxable income. References to consolidated taxable income (and consolidated tax liability) include references to the combined taxable income of the members (and their combined tax liability). For corporations filing separate returns, it ordinarily will not be necessary to actually combine their taxable incomes (and tax liabilities) because the taxable income (and tax liability) of one corporation does not affect the taxable income (or tax liability) of another corporation.

(c) Matching and acceleration principles of §1.1502–13—(1) Adjustments to the timing rules. Under this section, S’s losses and deductions are deferred until they are taken into account under the timing principles of the matching and acceleration rules of §1.1502–13(c) and (d) with appropriate adjustments. For example, if S sells depreciable property to B at a loss, S’s loss is deferred and taken into account under the principles of the matching rule of §1.1502–13(c) to reflect the difference between B’s depreciation taken into account with respect to the property and the depreciation that B would take into account if S and B were divisions of a single corporation; if S and B subsequently cease to be in a controlled group relationship with each other, S’s remaining loss is taken into account under the principles of the acceleration rule of §1.1502–13(d). For purposes of this section, the adjustments to §1.1502–13(c) and (d) include the following:

(i) Application on controlled group basis. The matching and acceleration rules apply on a controlled group basis, rather than a consolidated group basis. Thus if S and B are wholly-owned members of a consolidated group and 21% of the stock of S is sold to an unrelated person, S’s loss continues to be deferred under this section because S and B continue to be members of a controlled group even though S is no longer a member of the consolidated group. Similarly, S’s loss would continue to be deferred if S and B remain in a controlled group relationship after both corporations become nonmembers of their former consolidated group.

(ii) Different taxable years. If S and B have different taxable years, the taxable years that include a December 31 are treated as the same taxable years. If S or B has a short taxable year that does not include a December 31, the short year is treated as part of the succeeding taxable year that does include a December 31.
(iii) **Transfer to a section 267(b) or 707(b) related person.** To the extent S’s loss or deduction from an intercompany sale of property is taken into account under this section as a result of B’s transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under sections 267(b) or 707(b), or as a result of S or B becoming a nonmember that is related to any member under section 267(b), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer. The balance not allowed is treated as a loss referred to in section 267(d) if it is from a sale or exchange by B (rather than from a distribution).

(iv) **B’s item is excluded from gross income or noncapital and nondeductible.** To the extent S’s loss would be redetermined to be a noncapital, nondeductible amount under the principles of §1.1502–13 but is not redetermined because of paragraph (c)(2) of this section, then, if paragraph (c)(1)(iii) of this section does not apply, S’s loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. See §1.1502–13(c)(6)(ii).

(v) **Circularity of references.** References to deferral or elimination under the Internal Revenue Code or regulations do not include references to section 267(f) or this section. See, e.g., §1.1502–13(c)(6)(ii).

2. **Attributes generally not affected.** The matching and acceleration rules are not applied under this section to affect the attributes of S’s intercompany item, or cause it to be taken into account before it is taken into account under S’s separate entity method of accounting. However, the attributes of S’s intercompany item may be redetermined, or an item may be taken into account under S’s separate entity method of accounting, to the extent the transaction is also an intercompany transaction to which §1.1502–13 applies. Similarly, except to the extent the transaction is also an intercompany transaction to which §1.1502–13 applies, the matching and acceleration rules do not apply to affect the timing or attributes of B’s corresponding items.

(d) **Intercompany sales of inventory involving foreign persons—** (1) **General rule.** Section 267(a)(1) and this section do not apply to an intercompany sale of property that is inventory (within the meaning of section 1221(1)) in the hands of both S and B, if—

(i) The intercompany sale is in the ordinary course of S’s trade or business;

(ii) S or B is a foreign corporation; and

(iii) Any income or loss realized on the intercompany sale by S or B is not income or loss that is recognized as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864 (unless the income is exempt from taxation pursuant to a treaty obligation of the United States).

(2) **Intercompany sales involving related partnerships.** For purposes of paragraph (d)(1) of this section, a partnership and a foreign corporation described in section 267(b)(10) are treated as members, provided that the income or loss of the foreign corporation is described in paragraph (d)(1)(iii) of this section.

(3) **Intercompany sales in ordinary course.** For purposes of this paragraph (d), whether an intercompany sale is in the ordinary course of business is determined under all the facts and circumstances.

(e) **Treatment of a creditor with respect to a loan in nonfunctional currency.** Sections 267(a)(1) and this section do not apply to an exchange loss realized with respect to a loan of nonfunctional currency if—

(1) The loss is realized by a member with respect to nonfunctional currency loaned to another member;

(2) The loan is described in §1.988–1(a)(2)(i); and

(3) The loan is not in a hyperinflationary currency as defined in §1.988–1(f); and
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(4) The transaction does not have as a significant purpose the avoidance of Federal income tax.

(f) Receivables. If S acquires a receivable from the sale of goods or services to a nonmember at a gain, and S sells the receivable at fair market value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S’s income or gain from the sale to the nonmember that has been taken into account at the time the receivable is sold to B.

(g) Earnings and profits. A loss or deduction deferred under this section is not reflected in S’s earnings and profits before it is taken into account under this section. See, e.g., §§1.312–6(a), 1.312–7, and 1.1502–3(c)(2).

(h) Anti-avoidance rule. If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of this section.

(i) [Reserved]

(j) Examples. For purposes of the examples in this paragraph (j), unless otherwise stated, corporation P owns 75% of the only class of stock of subsidiaries S and B. X is a person unrelated to any member of the P controlled group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only activity, and no member has a special status. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred to as M (rather than as S or B). This section is illustrated by the following examples.

Example 1. Matching and acceleration rules.

(a) Facts. S holds land for investment with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. On a separate entity basis, S’s loss is long-term capital loss. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, B sells the land to X for $110.

(b) Matching rule. Under paragraph (b)(1) of this section, S’s sale of land to B is an intercompany sale. Under paragraph (c)(1) of this section, S’s $30 loss is taken into account under the timing principles of the matching rule of §1.1502–13(c) to reflect the difference for the year between B’s corresponding items taken into account and the recomputed corresponding items. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S’s $130 basis in the land and would have a $20 loss from the sale to X in Year 3. Consequently, S takes no loss into account in Years 1 and 2, and takes the entire $30 loss into account in Year 3 to reflect the $30 difference in that year between the $10 gain B takes into account and its $20 recomputed loss. The attributes of S’s intercompany items and B’s corresponding items are determined on a separate entity basis. Thus, S’s $30 loss is long-term capital loss and B’s $10 gain is ordinary income.

(c) Acceleration resulting from sale of B stock. The facts are the same as in paragraph (a) of this Example 1, except that on July 1 of Year 3 P sells all of its B stock to X (rather than B’s selling the land to X). Under paragraph (c)(1) of this section, S’s $30 loss is taken into account under the timing principles of the acceleration rule of §1.1502–13(d) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once B becomes a nonmember, S takes its $30 loss into account in Year 3 immediately before B becomes a nonmember. S’s loss is long-term capital loss.

(d) Subgroup principles applicable to sale of S and B stock. The facts are the same as in paragraph (a) of this Example 1, except that on July 1 of Year 3 P sells all of its S and B stock to X (rather than B’s selling the land to X). Under paragraph (b)(3) of this section, S and B are considered to remain members of a controlled group as long as they remain in a controlled group relationship with each other (whether or not in the original controlled group). P’s sale of their stock does not affect the controlled group relationship of S and B with each other. Thus, S’s loss is not taken into account as a result of P’s sale of the stock. Instead, S’s loss is taken into account based on subsequent events (e.g., B’s sale of the land to a nonmember).

Example 2. Distribution of loss property.

(a) Facts. S holds land with a basis of $210 and value of $100. On January 1 of Year 1, S distributes the land to P in a transaction to which section 311 applies. On July 1 of Year 3, P sells the land to X for $110.

(b) No loss taken into account. Under paragraph (b)(2) of this section, because P and S are not members of a consolidated group, §1.1502–13(f)(2)(iii) does not apply to cause S to recognize a $30 loss under the principles of section 311(b). Thus, S has no loss to be taken into account under this section. (If P and S were members of a consolidated group,
§ 1.1502-13(f)(2)(i)(ii) would apply to S's loss in addition to the rules of this section, and the loss would be taken into account in Year 3 as a result of P's sale to X.

Example 4. Company sale. (a) Facts. S holds land with a basis of $130. On January 1 of Year 1, S sells the land to B at a $100 gain. Since S does not take into account the loss under its separate entity method of accounting until Year 4, on July 1 of Year 3, B sells the land to X for $110.

(b) Timing. Under paragraph (b)(2) of this section, S's loss is determined on a separate entity basis. Under paragraph (c)(1) of this section, S's loss is not taken into account before it is taken into account under S's separate entity method of accounting. Thus, although B takes its corresponding gain into account in Year 3, S has no loss to take into account until Year 4. Once S's loss is taken into account in Year 4, it is not deferred under this section because B's corresponding gain has already been taken into account. (If S and B were members of a consolidated group, S would be treated under § 1.1502–13(b)(2)(iii) as taking the loss into account in Year 4.)

Example 5. Intercompany sale followed by installment sale. (a) Facts. S holds land for investment with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, B sells the land to X in exchange for X's $110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of $55x in Year 4 and $55x in Year 5. Section 453A applies to X's note.

(b) Timing and attributes. Under paragraph (c) of this section, S's $30x loss is taken into account under the timing principles of the matching rule of § 1.1502–13(c) to reflect the difference in each year between B's gain taken into account and its recomputed loss. Under section 453, B takes into account $5x of gain in Year 4 and in Year 5. Therefore, S takes $20x of its loss into account in Year 3 to reflect the $20x difference in that year between B's $0 loss taken into account and its $20x recomputed loss. In addition, S takes $5x of its loss into account in Year 4 and in Year 5 to reflect the $5x difference in each year between B's $5x gain taken into account and its $0 recomputed gain. Although S takes into account a loss and B takes into account a gain, the attributes of B's $10x gain are determined on a separate entity basis, and therefore the interest charge under section 453A(c) applies to B's $10x gain on the installment sale beginning in Year 3.

Example 6. Section 721 transfer to a related nonmember. (a) Facts. S owns land with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, B transfers the land to a partnership in exchange for a 40% interest in capital and profits in a transaction to which section 721 applies. P also owns a 25% interest in the capital and profits of the partnership.

(b) Timing. Under paragraph (c)(1)(i)(ii) of this section, because the partnership is a nonmember that is a related person under sections 267(b) and 7701(b), S's $30 loss is taken into account in Year 3, but only to the extent of any income or gain taken into account as a result of the transfer. Under section 721, no gain or loss is taken into account as a result of the transfer to the partnership, and thus none of S's loss is taken into account. Any subsequent gain recognized by the partnership with respect to the property is limited under section 267(d). (The results would be the same if the P group were a consolidated group, and B's sale to B were also subject to § 1.1502–13.)
Example 7. Receivables. (a) Controlled group. S owns goods with a $80 basis. In Year 1, S sells the goods to X for X's $100 note. The note bears a market rate of interest in excess of the applicable Federal rate, as P provides for payment of principal in Year 5. S takes into account $40 of income in Year 1 under its method of accounting. In Year 2, the note sells for $90 due to an increase in prevailing market interest rates, and S sells the note to B for its $90 fair market value.

(b) Loss not deferred. Under paragraph (f) of this section, S takes its $10 loss into account in Year 2. (If the sale were not at fair market value, paragraph (f) of this section would not apply and none of S's $10 loss would be taken into account in Year 2.)

(c) Consolidated group. Assume instead that P owns all of the stock of S and B, and the P group is a consolidated group. In Year 1, S sells X goods having a basis of $90 for X's $100 note (bearing a market rate of interest in excess of the applicable Federal rate, and providing for payment of principal in Year 5), and S takes into account $10 of income in Year 1. In Year 2, S sells the receivable to B for its $85 fair market value. In Year 3, P sells 25% of B's stock to X. Although paragraph (f) of this section provides that $10 of S's loss (i.e., the extent to which S's $15 loss does not exceed its $10 of income) is not deferred under this section based on subsequent events (e.g., B's collection of the note or P's sale of the remaining B stock to a nonmember), none of S's loss would be taken into account in Year 2.

Example 8. Selling member ceases to be a member. (a) Facts. P owns all of the stock of S and B, and the P group is a consolidated group. S has several historic assets, including land with a basis of $130 and value of $100. The land is not essential to the operation of S's business. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, P transfers all of S's stock to newly formed X in exchange for a 20% interest in X stock as part of a transaction to which section 351 applies. Although X holds many other assets, a principal purpose for P's transfer is to accelerate taking S's $30 loss into account. P has no plan or intention to dispose of the X stock.

(b) Timing. Under paragraph (c) of this section, S's $30 loss ordinarily is taken into account immediately before disposing of the S stock, under the timing principles of the acceleration rule of §1.1502–13(d). Although taking S's loss into account results in a $30 negative stock basis adjustment under §1.1502–32, because P has no plan or intention to dispose of its X stock, the negative adjustment will not immediately affect taxable income. P's transfer accelerates a loss that otherwise would be deferred, and an adjustment under paragraph (h) of this section is required. Thus, S's loss is never taken into account, and S's stock basis and earnings and profits are reduced by $30 under §§1.1502–32 and 1.1502–33 immediately before P's transfer of the S stock.

(c) Nonhistoric assets. Assume instead that, with a principal purpose to accelerate taking into account any further loss that may accrue in the value of the land without disposing of the land outside of the consolidated group, P forms M with a $100 contribution on January 1 of Year 1 and S sells the land to M for $100. On December 1 of Year 1, when the value of the land has decreased to $90, M sells the land to B for $90. On July 1 of Year 3, while B still owns the land, P sells all of M's stock to X and M becomes a nonmember. Under paragraph (c) of this section, M's $10 loss ordinarily is taken into account under the timing principles of the acceleration rule of §1.1502–13(d) immediately before M becomes a nonmember. (S's $30 loss is not taken into account under the timing principles of §1.1502–13(c) or §1.1502–13(d) as a result of M becoming a nonmember, but is taken into account based on subsequent events such as B's sale of the land to a nonmember or P's sale of the stock of S or B to a nonmember.) The land is not an historic asset of M and, although taking M's loss into account reduces P's basis in the M stock under §1.1502–32, the negative adjustment only eliminates the $10 duplicate stock loss. Under paragraph (h) of this section, M's loss is never taken into account. M's stock basis, and the earnings and profits of M and P, are reduced by $10 under §§1.1502–32 and 1.1502–33 immediately before P's sale of the M stock.

(k) Cross-reference. For additional rules applicable to the disposition, deconsolidation, or transfer of the stock of members of consolidated groups, see §§1.337(d)–2, 1.1502–13(f)(6), 1.1502–35, and 1.1502–36.

(l) Effective dates—(1) In general. This section applies with respect to transactions occurring in S's years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with
the result that items are duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items are treated inconsistently, prior law (and not this section) applies to the transaction.

(2) Avoidance transactions. This paragraph (l)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (1)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section.

(3) Prior law. For transactions occurring in S’s years beginning before July 12, 1995 see the applicable regulations issued under sections 267 and 1502. See, e.g., §§ 1.267(f)–1, 1.267(f)–1T, 1.267(f)–2T, 1.267(f)–3, 1.1502–13, 1.1502–13T, 1.1502–14, 1.1502–14T, and 1.1502–31 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).


§ 1.269–1 Meaning and use of terms.

As used in section 269 and §§1.269–2 through 1.269–7:

(a) Allowance. The term allowance refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

(b) Evasion or avoidance. The phrase evasion or avoidance is not limited to cases involving criminal penalties, or civil penalties for fraud.

(c) Control. The term control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of the corporation. For control to be “acquired on or after October 8, 1940”, it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940, and at all times thereafter, owns 40 percent of the stock of X Corporation and acquires on October 8, 1940, an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940, such assets to a newly organized Y Corporation in exchange for all the stock of Y Corporation, an acquisition within the meaning of such phrase is made by B on October 8, 1940. If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Z Corporation, then an acquisition within the meaning of such phrase is also made by Z Corporation on October 8, 1940, as well as by the shareholders of Z Corporation taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of Z on such date.

(d) Person. The term person includes an individual, a trust, an estate, a partnership, an association, a company or a corporation.

§ 1.269–2 Purpose and scope of section 269.

(a) General. Section 269 is designed to prevent in the instances specified therein the use of the sections of the Internal Revenue Code providing deductions, credits, or allowances in evading or avoiding Federal income tax. See §1.269–3.

(b) Disallowance of deduction, credit, or other allowance. Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases. Included in these cases are Gregory v. Helvering (1935) (293 U.S. 465; Ct. D. 911, C.B. XIV–1, 193); Griffiths v. Helvering (1939) (308 U.S. 355; Ct. D. 1431, C.B. 1940–1, 136); Higgins v. Smith (1940) (308 U.S. 473; Ct. D. 1434, C.B. 1940–1, 127); and J. D. & A. B. Spreckles Co. v. Commissioner (1940) (41 B.T.A. 370). In order to give effect to such principle, but not in limitation thereof, several provisions of the Code, for example, section 267 and section 269, specify with some particularity instances in which disallowance of the deduction, credit, or other allowance is required. Section 269 is also included in such provisions of the Code. The principle of law and the particular sections of the Code are not mutually exclusive and in appropriate circumstances they may operate together or they may operate separately. See, for example, §1.269–6.


§ 1.269–3 Instances in which section 269(a) disallows a deduction, credit, or other allowance.

(a) Instances of disallowance. Section 269 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in paragraphs (1) and (2) of section 269(a), are those in which:

(1) Any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) Any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation (not controlled, directly or indirectly, immediately before such acquisition by such acquiring corporation or its stockholders), the basis of which property in the hands of the acquiring corporation is determined by reference to the basis in the hands of the transferor corporation.

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person, or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. Thus, an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of section 269 even though it is the acquired corporation that is entitled to such deduction, credit, or other allowance in the determination of its tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 269 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the
transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom.

(b) Acquisition of control; transactions indicative of purpose to evade or avoid tax. If the requisite acquisition of control within the meaning of paragraph (1) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, in the absence of additional evidence to the contrary, ordinarily are indicative that the principal purpose for acquiring control was evasion or avoidance of Federal income tax:

(1) A corporation or other business enterprise (or the interest controlling such corporation or enterprise) with large profits acquires control of a corporation with current, past, or prospective credits, deductions, net operating losses, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit, or other allowance into conjunction with the income (see further §1.269–6). This subparagraph may be illustrated by the following example:

Example. Individual A acquires all of the stock of L Corporation which has been engaged in the business of operating retail drug stores. At the time of the acquisition, L Corporation has net operating loss carryovers aggregating $100,000 and its net worth is $100,000. After the acquisition, L Corporation continues to engage in the business of operating retail drug stores but the profits attributable to such business after the acquisition are not sufficient to absorb any substantial portion of the net operating loss carryovers. Shortly after the acquisition, individual A causes to be transferred to L Corporation the assets of a hardware business previously controlled by A which business produces profits sufficient to absorb a substantial portion of L Corporation’s net operating loss carryovers. The transfer of the profitable business, which has the effect of using net operating loss carryovers to offset gains of a business unrelated to that which produced the losses, indicates that the principal purpose for which the acquisition of control was made is evasion or avoidance of Federal income tax.

(2) A person or persons organize two or more corporations instead of a single corporation in order to secure the benefit of multiple surtax exemptions (see section 11(c)) or multiple minimum accumulated earnings credits (see section 535(c)(2) and (3)).

(3) A person or persons with high earning assets transfer them to a newly organized controlled corporation retaining assets producing net operating losses which are utilized in an attempt to secure refunds.

(c) Acquisition of property; transactions indicative of purpose to evade or avoid tax. If the requisite acquisition of property within the meaning of paragraph (2) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, in the absence of additional evidence to the contrary, ordinarily are indicative that the principal purpose for acquiring such property was evasion or avoidance of Federal income tax:

(1) A corporation acquires property having in its hands an aggregate carryover basis which is materially greater than its aggregate fair market value at the time of such acquisition and utilizes the property to create tax-reducing losses or deductions.

(2) A subsidiary corporation, which has sustained large net operating losses in the operation of business X and which has filed separate returns for the taxable years in which the losses were sustained, acquires high earning assets, comprising business Y, from its parent corporation. The acquisition occurs at a time when the parent would not succeed to the net operating loss carryovers of the subsidiary if the subsidiary were liquidated, and the profits of business Y are sufficient to offset a substantial portion of the net operating loss carryovers attributable to business X (see further Example 3 of §1.269–6).

(d) Ownership changes to which section 382(1)(5) applies; transactions indicative of purpose to evade or avoid tax.—(1) In general. Absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(1)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case (as defined

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in section 382(l)(5)(G)). The determination of whether the corporation carries on more than an insignificant amount of an active trade or business is made without regard to the continuity of business enterprise set forth in §1.382–1(d). The determination is based on all the facts and circumstances, including, for example, the amount of business assets that continue to be used, or the number of employees in the work force who continue employment, in an active trade or business (although not necessarily the historic trade or business). Where the corporation continues to utilize a significant amount of its business assets or work force, the requirement of carrying on more than an insignificant amount of an active trade or business may be met even though all trade or business activities temporarily cease for a period of time in order to address business exigencies.

(2) Effective date. The presumption under paragraph (d) of this section applies to acquisitions of control or property effected pursuant to a plan of reorganization confirmed by a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) after August 14, 1990.

(e) Relationship of section 269 to 11 U.S.C. 1129(d). In determining for purposes of section 269 of the Internal Revenue Code whether an acquisition pursuant to a plan of reorganization confirmed by a court in a title 11 of the United States Code was made for the principal purpose of evasion or avoidance of Federal income tax, the fact that a governmental unit did not seek a determination under 11 U.S.C. 1129(d) after August 14, 1990, is not taken into account and any determination by a court under 11 U.S.C. 1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling.


§ 1.269–5 Time of acquisition of control.

(a) In general. For purposes of section 269, an acquisition of control occurs when one or more persons acquire beneficial ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of share of all classes of stock of the corporation.

(b) Application of general rule to certain creditor acquisitions. (1) For purposes of section 269, creditors of an insolvent or bankrupt corporation (by themselves or in conjunction with other persons) acquire control of the corporation when they acquire beneficial ownership of stock of the corporation by the bankruptcy court confirms a plan of reorganization. The provisions of this section are illustrated by the following example.

Example. Corporation L files a petition under chapter 11 of the Bankruptcy Code on January 5, 1987. A creditors' committee is formed. On February 22, 1987, and upon the request of the creditors, the bankruptcy court removes the debtor-in-possession from business management and operations and appoints a trustee. The trustee consults regularly with the creditors' committee in formulating both short-term and long-term management decisions. After three years, the creditors approve a plan of reorganization in which the outstanding stock of Corporation L is canceled and its creditors receive shares of stock constituting all of the outstanding shares. The bankruptcy court confirms the plan of reorganization on March 23, 1990, and the plan is put into effect on May 25, 1990. For purposes of section 269, the creditors acquired control of Corporation L no earlier than March 23, 1990. Similarly, the determination of whether the creditors acquired control of Corporation L no earlier with the principal purpose of evasion or avoidance of Federal income tax is made by reference to the creditors' purposes as of no earlier than March 23, 1990.

[Example 2.]

Example 3. L Corporation has been sustaining net operating losses for a number of years. P Corporation, a profitable corporation, on December 31, 1955, acquires all the stock of L Corporation for the purpose of continuing and improving the operation of L Corporation's business. Under the provisions of sections 334(b)(2) and 381(a)(1), P Corporation would not succeed to L Corporation's net operating loss carryovers if L Corporation were liquidated pursuant to a plan of liquidation adopted within two years after the date of the acquisition. During 1956, P Corporation transfers a profitable business to L Corporation for the principal purpose of using the profits of such business to absorb the net operating loss carryovers of L Corporation. The transfer is such as to cause the basis of the transferred assets in the hands of L Corporation to be determined by reference to their basis in the hands of P Corporation. L Corporation's net operating loss carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382.

[Example 3.]
§ 1.269B–1 Stapled foreign corporations.

(a) Treatment as a domestic corporation—(1) General rule. Except as otherwise provided, if a foreign corporation is a stapled foreign corporation within the meaning of paragraph (b)(1) of this section, such foreign corporation will be treated as a domestic corporation for U.S. Federal income tax purposes. Accordingly, for example, the worldwide income of such corporation will be subject to the tax imposed by section 11. For application of the branch profits tax under section 884, and application of sections 871(a), 881, 1441, and 1442 to dividends and interest paid by a stapled foreign corporation, see §§1.884–1(h) and 1.884–4(d).

(2) Foreign owned exception. Paragraph (a)(1) of this section will not apply if a foreign corporation and a domestic corporation are stapled entities (as provided in paragraph (b) of this section) and such foreign and domestic corporations are foreign owned within the meaning of this paragraph (a)(2). A corporation will be treated as foreign owned if it is established to the satisfaction of the Commissioner that United States persons hold directly (or indirectly applying section 956(a)(2) and (3) and section 318(a)(4)) less than 50 percent of the total combined voting power of all classes of stock entitled to vote and less than 50 percent of the total value of the stock of such corporation. For the consequences of a stapled foreign corporation becoming or ceasing to be a stapled foreign corporation (e.g., a corporation that is no longer foreign owned) under this paragraph (a)(1), see paragraph (c) of this section.

(2) Related party ownership rule. For purposes of determining whether a foreign corporation is a stapled foreign corporation, the Commissioner may, at his discretion, treat interests that otherwise would be stapled interests as not being stapled if the same person or related persons (within the meaning of section 267(b) or 707(b)) hold stapled interests constituting more than 50 percent of the beneficial ownership of both corporations, and a principal purpose of the stapling of those interests is the avoidance of U.S. income tax. A stapling of interests may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes when taken together.

(3) Example. The principles of paragraph (b)(1) of this section are illustrated by the following example:

Example. USCo, a domestic corporation, and FCo, a foreign corporation, are publicly traded companies, each having two classes of stock outstanding. USCo’s class A shares, which constitute 75% of the value of all beneficial ownership in USCo, are stapled to FCo’s class B shares, which constitute 25% of the value of all beneficial ownership in FCo. USCo’s class B shares, which constitute 25%
of the value of all beneficial ownership in USCo, are stapled to FCo class A shares, which constitute 75% of the value of all beneficial ownership in FCo. Because more than 90% of the aggregate value of the stock of each corporation is stapled to the stock of the other corporation, USCo and FCo are stapled entities within the meaning of section 269B(c)(2).

(c) Changes in domestic or foreign status. The deemed conversion of a foreign corporation to a domestic corporation under section 269B is treated as a reorganization under section 368(a)(1)(F). Similarly, the deemed conversion of a corporation that is treated as a domestic corporation under section 269B to a foreign corporation is treated as a reorganization under section 368(a)(1)(F).

For the consequences of a deemed conversion, including the closing of a corporation’s taxable year, see §§1.367(a)-1T(e), (f) and 1.367(b)-2(f).

(d) Includible corporation—(1) Except as provided in paragraph (d)(2) of this section, a stapled foreign corporation treated as a domestic corporation under section 269B nonetheless is treated as a foreign corporation in determining whether it is an includible corporation within the meaning of section 1504(b). Thus, for example, a stapled foreign corporation is not eligible to join in the filing of a consolidated return under section 1501, and a dividend paid by such corporation is not a qualifying dividend under section 243(b), unless a valid section 1504(d) election is made with respect to such corporation.

(2) A stapled foreign corporation is treated as a domestic corporation in determining whether it is an includible corporation under section 1504(b) for purposes of applying §§1.904(c)-1 and 1.861-1T(d)(6).

(e) U.S. treaties—(1) A stapled foreign corporation that is treated as a domestic corporation under section 269B may not claim an exemption from U.S. income tax or a reduction in U.S. tax rates by reason of any treaty entered into by the United States.

(2) The principles of this paragraph (e) are illustrated by the following example:

Example. FCo, a Country X corporation, is a stapled foreign corporation that is treated as a domestic corporation under section 269B. FCo qualifies as a resident of Country X pursuant to the income tax treaty between the United States and Country X. Under such treaty, the United States is permitted to tax business profits of a Country X resident only to the extent that the business profits are attributable to a permanent establishment of the Country X resident in the United States. While FCo earns income from sources within and without the United States, it does not have a permanent establishment in the United States within the meaning of the relevant treaty. Under paragraph (e)(1) of this section, however, FCo is subject to U.S. Federal income tax on its income as a domestic corporation without regard to the provisions of the U.S.-Country X treaty and therefore without regard to the fact that FCo has no permanent establishment in the United States.

(f) Tax assessment and collection procedures—(1) In general. (i) Any income tax imposed on a stapled foreign corporation by reason of its treatment as a domestic corporation under section 269B (whether such income tax is shown on the stapled foreign corporation’s U.S. Federal income tax return or determined as a deficiency in income tax) shall be assessed as the income tax liability of such stapled foreign corporation.

(ii) Any income tax assessed as a liability of a stapled foreign corporation under paragraph (f)(1)(i) of this section shall be considered as having been properly assessed as an income tax liability of the stapled domestic corporation (as defined in paragraph (f)(4)(i) of this section) and all 10-percent shareholders of the stapled foreign corporation (as defined in paragraph (f)(4)(ii) of this section). The date of such deemed assessment shall be the date the income tax liability of the stapled foreign corporation was properly assessed. The Commissioner may collect such income tax from the stapled domestic corporation under the circumstances set forth in paragraph (f)(2) of this section and may collect such income tax from any 10-percent shareholders of the stapled foreign corporation under the circumstances set forth in paragraph (f)(3) of this section.

(2) Collection from domestic stapled corporation. If the stapled foreign corporation does not pay its income tax liability that was properly assessed, the unpaid balance of such income tax or any portion thereof may be collected from
the stapled domestic corporation, provided that the following conditions are satisfied—

(i) The Commissioner has issued a notice and demand for payment of such income tax to the stapled foreign corporation in accordance with §301.6303–1 of this Chapter;

(ii) The stapled foreign corporation has failed to pay the income tax by the date specified in such notice and demand;

(iii) The Commissioner has issued a notice and demand for payment of the unpaid portion of such income tax to the stapled domestic corporation in accordance with §301.6303–1 of this Chapter.

(3) Collection from 10-percent shareholders of the stapled foreign corporation. The unpaid balance of the stapled foreign corporation’s income tax liability may be collected from a 10-percent shareholder of the stapled foreign corporation, limited to each such shareholder’s income tax liability as determined under paragraph (f)(4)(iv) of this section, provided the following conditions are satisfied—

(i) The Commissioner has issued a notice and demand for the unpaid portion of the stapled foreign corporation’s income tax liability as provided in paragraph (f)(2)(iii) of this section;

(ii) The stapled domestic corporation has failed to pay the income tax by the date specified in such notice and demand;

(iii) The Commissioner has issued a notice and demand for payment of the unpaid portion of such income tax to the stapled domestic corporation in accordance with §301.6303–1 of this Chapter.

(4) Special rules and definitions. For purposes of this paragraph (f), the following rules and definitions apply:

(i) Stapled domestic corporation. A domestic corporation is a stapled domestic corporation with respect to a stapled foreign corporation if such domestic corporation and the stapled foreign corporation are stapled entities as described in paragraph (b)(1) of this section.

(ii) 10-percent shareholder. A 10-percent shareholder of a stapled foreign corporation is any person that owned directly 10 percent or more of the total value or total combined voting power of all classes of stock in the stapled foreign corporation for any day of the stapled foreign corporation’s taxable year with respect to which the income tax liability relates.

(3) Determination of a 10-percent shareholder’s income tax liability. The income tax liability of a 10-percent shareholder of a stapled foreign corporation, for the income tax of the stapled foreign corporation under section 269B and this section, is determined by assigning an equal portion of the total income tax liability of the stapled foreign corporation for the taxable year to each day in such corporation’s taxable year, and then dividing that portion ratably among the shares outstanding for that day on the basis of the relative values of such shares. The liability of any 10-percent shareholder for this purpose is the sum of the income tax liability allocated to the shares held by such shareholder for each day in the taxable year.

(v) Income tax. The term income tax means any income tax liability imposed on a domestic corporation under title 26 of the United States Code, including additions to tax, additional amounts, penalties, and interest related to such income tax liability.

(g) Effective dates—(1) Except as provided in this paragraph (g), the provisions of this section are applicable for taxable years that begin after July 29, 2005.

(2) Paragraphs (d)(1) and (f) of this section (except as applied to the collection of tax from any 10-percent shareholder of a stapled foreign corporation that is a foreign person) are applicable beginning on—

(i) July 18, 1984, for any foreign corporation that became stapled to a domestic corporation after June 30, 1983; and

(ii) January 1, 1987, for any foreign corporation that was stapled to a domestic corporation as of June 30, 1983.

(3) Paragraph (d)(2) of this section is applicable for taxable years beginning after July 22, 2003, except that in the
case of a foreign corporation that becomes stapled to a domestic corporation on or after July 22, 2003, paragraph (d)(2) of this section applies for taxable years ending on or after July 22, 2003.

(4) Paragraph (e) of this section is applicable beginning on July 18, 1984, except as provided in paragraph (g)(5) of this section.

(5) In the case of a foreign corporation that was stapled to a domestic corporation as of June 30, 1983, which was entitled to claim benefits under an income tax treaty as of that date, and which remains eligible for such treaty benefits, paragraph (e) of this section will not apply to such foreign corporation and for all purposes of the Internal Revenue Code such corporation will continue to be treated as a foreign entity. The prior sentence will continue to apply even if such treaty is subsequently modified by protocol, or superseded by a new treaty, so long as the stapled foreign corporation continues to be eligible to claim such treaty benefits. If the treaty benefits to which the stapled foreign corporation was entitled as of June 30, 1983, are terminated, then a deemed conversion of the foreign corporation to a domestic corporation shall occur pursuant to paragraph (c) of this section as of the date of such termination.

[T.D. 9216, 70 FR 43758, July 29, 2005]

§ 1.270–1 Limitation on deductions allowable to individuals in certain cases.

(a) Recomputation of taxable income. (1) Under certain circumstances, section 270 limits the deductions (other than certain deductions described in subsection (b) thereof) attributable to a trade or business carried on by an individual which are otherwise allowable to such individual under the provisions of chapter 1 of the Code or the corresponding provisions of prior revenue laws. If, in each of five consecutive taxable years (including at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954), the deductions attributable to a trade or business carried on by an individual (other than the specially treated deductions described in paragraph (b) of this section) exceed the gross income derived from such trade or business by more than $50,000, the taxable income computed under section 63 (or the net income computed under the corresponding provisions of prior revenue laws) of such individual shall be recomputed for each of such taxable years.

(2) In recomputing the taxable income (or the net income, in the case of taxable years which are otherwise subject to the Internal Revenue Code of 1939) for each of the five taxable years, the deductions (other than the specially treated deductions described in paragraph (b) of this section with the exception of the net operating loss deduction) attributable to the trade or business carried on by the individual shall be allowed only to the extent of (i) the gross income derived from such trade or business, plus (ii) $50,000. The specially treated deductions described in paragraph (b) of this section (other than the net operating loss deduction) shall each be allowed in full. The net operating loss deduction, to the extent attributable to such trade or business, shall be disallowed in its entirety. Thus, a carryover or a carryback of a net operating loss so attributable, either from a year within the period of five consecutive taxable years or from a taxable year outside of such period, shall be ignored in making the recomputation of taxable income or net income, as the case may be.

(3) The limitations on deductions provided by section 270 are also applicable in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover or carryback from any year which falls within the provisions of section 270 to any year which does not fall within such provisions. Also, in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover from a year which falls within the provisions of section 270 to a year which does not fall within such provisions, the amount of net operating loss is to be reduced by the taxable income or net income, as the case may be (computed as provided in §1.172–5, or 26 CFR (1939) 39.122–4(c) (Regulations 118), as the case may be and, in the case of any taxable year which falls within the provisions of section 270, determined after
the application of section 270, of any taxable year preceding or succeeding the taxable year of the net operating loss to which such loss must first be carried back or carried over under the provisions of section 172(b), or the corresponding provisions of prior revenue laws, even though the net operating loss deduction is not an allowable deduction for such preceding or succeeding taxable year.

(4) If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses and the gross income derived therefrom shall not be aggregated in determining whether the deductions (other than the specially treated deductions) exceed the gross income derived from such trades or businesses by more than $50,000 in any taxable year. For the purposes of section 270, each trade or business shall be considered separately. However, where a particular business of an individual is conducted in one or more forms such as a partnership, joint venture, or individual proprietorship, the individual’s share of the profits and losses from each business unit must be aggregated to determine the applicability of section 270. See paragraphs (a)(8)(ii) and (b) of §1.702–1, relating to applicability of section 270 to a partner. Where it is established that for tax purposes a husband and wife are partners in the same trade or business or that each is participating independently of the other in the same trade or business with his and her own money, the husband’s gross income and deductions from that trade or business shall be considered separately from the wife’s gross income and deductions from that trade or business even though they file a joint return. Where a taxpayer is engaged in a trade or business in a community property State under circumstances such that the income therefrom is considered to be community income, the taxpayer and his spouse are treated for purposes of section 270 as two individuals engaged separately in the same trade or business and the gross income and deductions attributable to the trade or business are allocated one-half to the taxpayer and one-half to the spouse. Where several business activities emanate from a single commodity, such as oil or gas or a tract of land, it does not necessarily follow that such activities are one business for the purposes of section 270. However, in order to be treated separately, it must be established that such business activities are actually conducted separately and are not closely interrelated with each other. For the purposes of section 270, the trade or business carried on by an individual must be the same in each of the five consecutive years in which the deductions (other than the specially treated deductions) exceed the gross income derived from such trade or business by more than $50,000.

(5) For the purposes of section 270, a taxable year may be part of two or more periods of five consecutive taxable years. Thus, if the deductions (other than the specially treated deductions) attributable to a trade or business carried on by an individual exceed the gross income therefrom by more than $50,000 for six consecutive taxable years, the fifth year of such six consecutive taxable years shall be considered to be a part both of a five-year period beginning with the first and ending with the fifth taxable year and of a five-year period beginning with the second and ending with the sixth taxable year.

(6) For the purposes of section 270, a short taxable year required to effect a change in accounting period constitutes a taxable year. In determining the applicability of section 270 in the case of a short taxable year, items of income and deduction are not annualized.

(b) Specially treated deductions. (1) For the purposes of section 270 and paragraph (a) of this section, the specially treated deductions are:

(i) Taxes,

(ii) Interest,

(iii) Casualty and abandonment losses connected with a trade or business deductible under section 165(c)(1) or the corresponding provisions of prior revenue laws,

(iv) Losses and expenses of the trade or business of farming which are directly attributable to drought,

(v) The net operating loss deduction allowed by section 172, or the corresponding provisions of prior revenue laws, and
(vi) Expenditures as to which a taxpayer is given the option, under law or regulations, either (a) to deduct as expenses when incurred, or (b) to defer or capitalize.

(2) For the purpose of subparagraph (1)(iv) of this paragraph, an individual is engaged in the “trade or business of farming” if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. An individual who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the trade or business of farming. However, an individual who receives a fixed rental (without reference to production) is engaged in the trade or business of farming only if he participates to a material extent in the operation or management of the farm. An individual engaged in forestry or the growing of timber is not thereby engaged in the trade or business of farming. An individual cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the trade or business of farming. The term farm is used in its ordinarily accepted sense and includes stock, dairy, poultry, fruit, crop, and truck farms, and also plantations, ranches, ranges, and orchards. An individual is engaged in the trade or business of farming if he is a member of a partnership engaged in the trade or business of farming.

(3) In order for losses and expenses of the trade or business of farming to qualify as specially treated deductions under subparagraph (1)(iv) of this paragraph such losses and expenses must be directly attributable to drought conditions and not to other causes such as faulty management or unfavorable market conditions. In general, the following are the types of losses and expenses which, if otherwise deductible, may qualify as specially treated deductions under subparagraph (1)(iv) of this paragraph:

(i) Losses for damages to or destruction of property as a result of drought conditions, if such property is used in the trade or business of farming or is purchased for resale in the trade or business of farming;

(ii) Expenses directly related to raising crops or livestock which are destroyed or damaged by drought. Included in this category are, for example, payments for labor, fertilizer, and feed used in raising such crops or livestock. If such crops or livestock to which the expenditures relate are only partially destroyed or damaged by drought then only a proportionate part of the expenditures is regarded as specially treated deductions; and

(iii) Expenses which would not have been incurred in the absence of drought conditions, such as expenses for procuring pasture or additional supplies of water or feed.

(4) The expenditures referred to in subparagraph (1)(vi) of this paragraph include, but are not limited to, intangible drilling and development costs in the case of oil and gas wells as provided in section 263(c) and the regulations thereunder, and expenditures for the development of a mine or other natural deposit (other than an oil or gas well) as provided in section 616 and the regulations thereunder.

(5) The provisions of section 270(b) do not operate to make an expenditure a deductible item if it is not otherwise deductible under the law applicable to the particular year in which it was incurred. Thus, for example, if it is necessary, pursuant to the provisions of section 270, to recompute the taxable or net income of an individual for the taxable years 1950 through 1954, the individual in making the recomputation may not deduct expenditures paid or incurred in the years 1950 through 1953 which must be capitalized under the law applicable to those years, even though the expenditures are deductible under the Code.

(c) Applicability to taxable years otherwise subject to the Internal Revenue Code of 1939. The net income of a taxable year otherwise subject to the Internal Revenue Code of 1939 shall be recomputed pursuant to section 270 if (i) such taxable year is included in a period of five consecutive taxable years which includes at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954, and (ii) the deductions (other than the specially treated deductions specified in section 270(b)) for each taxable year in such five-year period exceed the $50,000 limitation specified in section 270. As described in paragraph (a)(5) of this paragraph, § 1.270-1
section, a taxable year may be part of two or more periods of five consecutive taxable years, one meeting the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939 and the other meeting the requirements for recomputation pursuant to section 270 of the Internal Revenue Code of 1954, then the recomputation for such taxable year shall be made pursuant to section 270. For example, if a calendar year taxpayer sustains a loss from a trade or business for each of the years 1949 through 1954, the years 1950, 1951, 1952, and 1953 may be a part of two such periods of five consecutive taxable years. If, however, a taxable year is part of a period which meets the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939, but is not part of a period which meets the requirements for recomputation, pursuant to section 270, then a recomputation of net income for such taxable year must be made pursuant to section 130.

(d) Redetermination of tax. The tax imposed by Chapter 1 of the Code, or by the corresponding provisions of prior revenue laws, for each of the five consecutive taxable years specified in paragraph (a) of this section shall be redetermined upon the basis of the taxable income or net income of the individual, as the case may be, recomputed in the manner described in paragraph (a) of this section. If the assessment of a deficiency is prevented (except for the provisions of Part II (section 1311 and following), Subchapter Q, Chapter 1 of the Code, relating to the effect of limitations and other provisions in income tax cases) by the operation of any provision of law (e.g., sections 6501 and 6502, or the corresponding provisions of prior revenue laws, relating to the period of limitations upon assessment and collection) except section 7122, or the corresponding provisions of prior revenue laws, relating to compromises, or by any rule of law (e.g., res judicata), then the excess of the tax recomputed as described in paragraph (d) of this section over the tax previously determined may be assessed and collected even though in fact there is no actual deficiency, as defined in section 6211(a), in respect of the given taxable year.

(e) Assessment of tax. Any amount determined as a deficiency in the manner described in paragraph (d) of this section in respect of any taxable year of the five consecutive taxable years specified in paragraph (a) of this section may be assessed and collected as if on the date of the expiration of the period of limitation for the assessment of a deficiency for the fifth taxable year of such five consecutive taxable years, one year remained before the expiration of the period of limitation upon assessment for the taxable year in respect of which the deficiency is determined. If the taxable year is one in respect of which an assessment could be made without regard to section 270, the amount of the actual deficiency as defined in section 6211(a) (whether it is greater than, equal to, or less than the deficiency determined under section 270(c)) shall be assessed and collected. However, if the assessment of a deficiency for such taxable year would be prevented by any provision of law (e.g., the period of limitation upon the assessment of tax) except section 7122, or the corresponding provision of prior revenue laws, relating to compromises, or by the operation of any rule of law (e.g., res judicata), then the excess of the tax recomputed as described in paragraph (d) of this section over the tax previously determined may be assessed and collected.

(f) Effective date; cross reference. The provisions of section 270 and this section apply to taxable years beginning before January 1, 1970. Thus, for instance, if the taxpayer had a profit of $2,000 attributable to a trade or business in 1965, section 270 and this section would not apply to the taxable years 1966 through 1970, even though he had losses of more than $50,000 in each of the 5 years ending with 1970. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see
§ 1.271–1 Debts owed by political parties.

(a) General rule. In the case of a taxpayer other than a bank (as defined in section 581 and the regulations thereunder), no deduction shall be allowed under section 166 (relating to bad debts) or section 165(g) (relating to worthlessness of securities) by reason of the worthlessness of any debt, regardless of how it arose, owed by a political party. For example, it is immaterial that the debt may have arisen as a result of services rendered or goods sold or that the taxpayer included the amount of the debt in income. In the case of a bank, no deduction shall be allowed unless, under the facts and circumstances, it appears that the bad debt was incurred to or purchased by, or the worthless security was acquired by, the taxpayer in accordance with its usual commercial practices. Thus, if a bank makes a loan to a political party not in accordance with its usual commercial practices but solely because the president of the bank has been active in the party no bad debt deduction will be allowed with respect to the loan.

(b) Definitions—(1) Political party. For purposes of this section and §1.276–1, the term political party means a political party (as commonly understood), a National, State, or local committee thereof, or any committee, association, or organization, whether incorporated or not, which accepts contributions (as defined in subparagraph (2) of this paragraph) or makes expenditures (as defined in subparagraph (3) of this paragraph) for the purpose of influencing or attempting to influence the election of presidential or vice-presidential electors, or the selection, nomination, or election of any individual to any Federal, State, or local elective public office, whether or not such individual or electors are selected, nominated, or elected. Accordingly, a political party includes a committee or other group which accepts contributions or makes expenditures for the purpose of promoting the nomination of an individual for an elective public office in a primary election, or in any convention, meeting, or caucus of a political party. It is immaterial whether the contributions or expenditures are accepted or made directly or indirectly. Thus, for example, a committee or other group, is considered to be a political party, if, although it does not expend any funds, it turns funds over to another organization, which does expend funds for the purpose of attempting to influence the nomination of an individual for an elective public office. An organization which engages in activities which are truly nonpartisan in nature will not be considered a political party merely because it conducts activities with respect to an election campaign if, under all the facts and circumstances, it is clear that its efforts are not directed to the election of the candidates of any particular party or parties or to the selection, nomination or election of any particular candidate. For example, a committee or group will not be treated as a political party if it is organized merely to inform the electorate as to the identity and experience of all candidates involved, to present on a nonpreferential basis the issues or views of the parties or candidates as described by the parties or candidates, or to provide a forum in which the candidates are freely invited on a nonpreferential basis to discuss or debate the issues.

(2) Contributions. For purposes of this section and §1.276–1, the term contributions includes a gift, subscription, loan, advance, or deposit, of money or anything of value, and includes a contract, promise, or agreement to make a contribution, whether or not legally enforceable.

(3) Expenditures. For purposes of this section and §1.276–1, the term expenditures includes a payment, distribution, loan, advance, deposit, or gift, of money or anything of value, and includes a contract, promise, or agreement to make an expenditure, whether or not legally enforceable.

[T.D. 6996, 34 FR 832, Jan. 18, 1969]
Expenditures relating to disposal of coal or domestic iron ore.

(a) Introduction. Section 272 provides special treatment for certain expenditures paid or incurred by a taxpayer in connection with a contract (hereafter sometimes referred to as a “coal royalty contract” or “iron ore royalty contract”) for the disposal of coal or iron ore the gain or loss from which is treated under section 631(c) as a section 1231 gain or loss on the sale of coal or iron ore. See paragraph (e) of §1.631–3 for special rules relating to iron ore. The expenditures covered by section 272 are those which are attributable to the making and administering of such a contract or to the preservation of the economic interest retained under the contract. For examples of such expenditures, see paragraph (d) of this section. For a taxable year in which gross royalty income is realized under the contract of disposal, such expenditures shall not be allowed as a deduction. Instead, they are to be added to the adjusted depletion basis of the coal or iron ore disposed of in the taxable year in computing gain or loss under section 631(c). However, where no gross royalty income is realized under the contract of disposal in a particular taxable year, such expenditure shall be treated without regard to section 272.

(b) In general. (1) Where the disposal of coal or iron ore is covered by section 631(c), the provisions of section 272 and this section shall be applicable for a taxable year in which there is income under the contract of disposal. For purposes of section 272 and this section, the term income means gross amounts received or accrued which are royalties or bonuses in connection with a contract to which section 631(c) applies.) All expenditures paid or incurred by the taxpayer during the taxable year which are attributable to the making and administering of the contract disposing of the coal or iron ore and all expenditures paid or incurred during the taxable year in order to preserve the owner’s economic interest retained under the contract shall be disallowed as deductions in computing taxable income for the taxable year. The sum of such expenditures and the adjusted depletion basis of the coal or iron ore disposed of in the taxable year shall be used in determining the amount of gain or loss with respect to the disposal. See §1.631–3. For special rule in case of loss, see paragraph (c) of this section. Section 272 and this section do not apply to capital expenditures, and such expenditures are not taken into account in computing gain or loss under section 631(c) except to the extent they are properly part of the depletable basis of the coal or iron ore.

(2) The expenditures covered under section 272 and this section are disallowed as a deduction only with respect to a taxable year in which income is realized under the coal royalty contract (or iron ore royalty contract) to which such expenditures are attributable. Where no income is realized under the contract in a taxable year, these expenditures shall be deducted as expenses for the production of income, or as a business expense, or they may be treated under section 266 (relating to taxes and carrying charges) if applicable.

(3) The provisions of section 272 and this section apply to a taxable year in which income from the disposal by the owner of coal or iron ore held by him for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is subject to the provisions of section 631(c) even though the actual mining of coal or iron ore under the coal royalty contract (or iron ore royalty contract) does not take place during the taxable year. Where the right under the contract to mine coal or iron ore for which advance payment has been made expires, terminates, or is abandoned before the coal or iron ore is mined, and paragraph (c) of §1.631–3 requires the owner to recompute his tax with respect to such payment, the recomputation must be made without applying the provisions of section 272 and this section.

(c) Losses. If, in any taxable year, the expenditures referred to in section 272 and this section plus the adjusted depletion basis (as defined in paragraph (b)(2) of §1.631–3) of the coal or iron ore disposed of during the taxable year exceed the amount realized under the contract which is subject to section 631(c) during the taxable year, such excess shall be considered under section

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1231 as a loss from the sale of property used in the trade or business and, to the extent not availed of as a reduction of gain under that section, shall be a loss deductible under section 165(a) (relating to the deduction of losses generally).

(d) Examples of expenditures. (1) The expenditures referred to in section 272 include, but are not limited to, the following items, if such items are attributable to the making or administering of the contract or preserving the economic interest therein: Ad valorem taxes imposed by State or local authorities, costs of fire protection, costs of insurance (other than liability insurance), costs incurred in administering the contract (including costs of bookkeeping and technical supervision), interest on loans, expenses of flood control, legal and technical expenses, and expenses of measuring and checking quantities of coal or iron ore disposed of under the contract. Whether the interest on loans is attributable to the making or administering of the contract or preserving the economic interest therein will depend upon the use to which the borrowed monies are put.

(2) Any expenditure referred to in this section which is applicable to more than one coal royalty contract or iron ore royalty contract shall be reasonably apportioned to each of such contracts. Furthermore, if an expenditure applies only in part to the making or administering of the contract or the preservation of the economic interest, then only such part shall be treated under section 272. The apportionment of the expenditure shall be made on a reasonable basis. For example, where a taxpayer has other income (such as income from oil or gas royalties, rentals, right of way fees, interest, or dividends) as well as income under section 631(c), and where the salaries of some of its employees or other expenses relate to both classes of income, such expenses shall be allocated reasonably between the income subject to section 631(c) and the other income. Where a taxpayer has more than one coal royalty contract or iron ore royalty contract, expenditures under this section relating to a contract from which no income has been received in the taxable year may not be allocated to income from another contract from which income has been received in the taxable year.

(3) The taxpayer may have expenses which are not attributable even partly to making and administering a coal royalty contract or iron ore royalty contract or to the preservation of the economic interest retained under the contract and, accordingly, are not included in the expenditures described in section 272. These include such items as ad valorem taxes imposed by State or local authorities on property not covered by the contract, salaries, wages, or other expenses entirely incident to the ownership and protection of such property and depreciation of improvements thereon, fire insurance on such property, charitable contributions, and similar expenses unrelated to the making or to the administering of coal royalty contracts or iron ore royalty contracts or preserving the taxpayer’s economic interest retained therein.

(e) Nonapplication of section. For purposes of section 543, the provisions of section 272 shall have no application. For example, the taxpayer may, for the purposes of section 543(a)(3)(C) or the corresponding provisions of prior income tax laws, include in the sum of the deductions which are allowable under section 162 an amount paid to an attorney as compensation for legal services rendered in connection with the making of a coal royalty contract or iron ore royalty contract (assuming the expenditure otherwise qualifies under section 162 as an ordinary and necessary expense incurred in the taxpayer’s trade or business), even though such expenditure is disallowed as a deduction under section 272.

§ 1.273–1 Life or terminable interests.

Amounts paid as income to the holder of a life or a terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called by depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up
the value of the expected future pay-
ments as corpus or principal and claim
deduction for shrinkage or exhaustion
thereof due to the passage of time. For
the treatment generally of distribu-
tions to beneficiaries of an estate or
trust, see Subparts A, B, C, and D (sec-
tion 641 and following), Subchapter J,
Chapter 1 of the Code, and the regula-
tions thereunder. For basis of property
acquired from a decedent and by gifts
and transfers in trust, see sections 1014
and 1015, and the regulations there-
under.

§ 1.274–1 Disallowance of certain en-
tertainment, gift and travel ex-
"penses.

Section 274 disallows in whole, or in
part, certain expenditures for enter-
tainment, gift and travel which would
otherwise be allowable under Chapter 1
of the Code. The requirements imposed
by section 274 are in addition to the re-
quirements for deductibility imposed
by other provisions of the Code. If a de-
duction is claimed for an expenditure
for entertainment, gift, or travel, the
taxpayer must first establish that it is
otherwise allowable as a deduction
under Chapter 1 of the Code before the
provisions of section 274 become appli-
cable. An expenditure for entertain-
ment, to the extent it is lavish or ex-
travagant, shall not be allowable as a
deduction. The taxpayer should then
substantiate such an expenditure in ac-
cordance with the rules under section
274(d). See §1.274–5. Section 274 is a dis-
allowance provision exclusively, and
does not make deductible any expense
which is disallowed under any other
provision of the Code. Similarly, sec-
tion 274 does not affect the includability
of an item in, or the ex-
cludability of an item from, the gross
income of any taxpayer. For specific
provisions with respect to the deduc-
tibility of expenditures: for an activity
of a type generally considered to con-
stitute entertainment, amusement, or
recreation, and for a facility used in
connection with such an activity, as
well as certain travel expenses of a
spouse, etc., see §1.274–2; for expenses
for gifts, see §1.274–3; for expenses for
foreign travel, see §1.274–4; for expendi-
tures deductible without regard to busi-
tness activity, see §1.274–6; and for
treatment of personal portion of enter-
tainment facility, see §1.274–7.

[T.D. 6659, 28 FR 6499, June 25, 1963, as
amended by T.D. 8666, 61 FR 27006, May 30,
1996]

§ 1.274–2 Disallowance of deductions
for certain expenses for entertain-
mament, amusement, recreation, or
travel.

(a) General rules—(1) Entertainment ac-
tivity. Except as provided in this sec-
tion, no deduction otherwise allowable
under Chapter 1 of the Code shall be al-
lowed for any expenditure with respect
to entertainment unless the taxpayer
establishes:

(i) That the expenditure was directly
related to the active conduct of the
taxpayer’s trade or business, or
(ii) In the case of an expenditure di-
rectly preceding or following a sub-
stantial and bona fide business discus-
sion (including business meetings at a
convention or otherwise), that the ex-
penditure was associated with the ac-
tive conduct of the taxpayer’s trade or
business.

Such deduction shall not exceed the
portion of the expenditure directly re-
lated to (or in the case of an expendi-
ture described in subdivision (ii) of this
subparagraph, the portion of the ex-
penditure associated with) the active
conduct of the taxpayer’s trade or busi-
ness.

(2) Entertainment facilities—(i) Expendi-
tures paid or incurred after December 31,
1978, and not with respect to a club. Ex-
cept as provided in this section with re-
spect to a club, no deduction otherwise
allowable under chapter 1 of the Code
shall be allowed for any expenditure
paid or incurred after December 31,
1978, with respect to a facility used in
connection with entertainment.

(ii) Expenditures paid or incurred be-
fore January 1, 1979, with respect to en-
tertainment facilities, or paid or incurred
before January 1, 1994, with respect to
clubs—(a) Requirements for deduction.
Except as provided in this section, no
deduction otherwise allowable under
chapter 1 of the Internal Revenue Code
shall be allowed for any expenditure
paid or incurred before January 1, 1979,
with respect to a facility used in con-
nection with entertainment, or for any
expenditure paid or incurred before
January 1, 1994, with respect to a club used in connection with entertainment, unless the taxpayer establishes—

(1) That the facility or club was used primarily for the furtherance of the taxpayer’s trade or business; and

(2) That the expenditure was directly related to the active conduct of that trade or business.

(b) Amount of deduction. The deduction allowable under paragraph (a)(2)(ii)(A) of this section shall not exceed the portion of the expenditure directly related to the active conduct of the taxpayer’s trade or business.

(iii) Expenditures paid or incurred after December 31, 1993, with respect to a club—

(a) In general. No deduction otherwise allowable under chapter 1 of the Internal Revenue Code shall be allowed for amounts paid or incurred after December 31, 1993, for membership in any club organized for business, pleasure, recreation, or other social purpose. The purposes and activities of a club, and not its name, determine whether it is organized for business, pleasure, recreation, or other social purpose. Clubs organized for business, pleasure, recreation, or other social purpose include any membership organization if a principal purpose of the organization is to conduct entertainment activities for members of the organization or their guests or to provide members or their guests with access to entertainment facilities within the meaning of paragraph (e)(2) of this section. Clubs organized for business, pleasure, recreation, or other social purpose include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to constitute entertainment such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer’s family. The term entertainment means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer’s family. The term entertainment may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family. The term entertainment does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as (a) supper money provided by an employer to his employee working overtime, (b) a hotel room maintained by an employer for lodging of his employees while in business travel status, or (c) an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. On the other

(3) Cross references. For definition of the term entertainment, see paragraph (b)(1) of this section. For the disallowance of deductions for the cost of admission to a dinner or program any part of the proceeds of which inures to the use of a political party or political candidate, and cost of admission to an inaugural event or similar event identified with any political party or political candidate, see §1.276–1. For rules and definitions with respect to:

(i) “Directly related entertainment”, see paragraph (c) of this section,

(ii) “Associated entertainment”, see paragraph (d) of this section,

(iii) “Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs”, see paragraph (e) of this section, and

(iv) “Specific exceptions” to the disallowance rules of this section, see paragraph (f) of this section.

(b) Definitions—(1) Entertainment defined—(i) In general. For purposes of this section, the term entertainment means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer’s family. The term entertainment may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family. The term entertainment does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as (a) supper money provided by an employer to his employee working overtime, (b) a hotel room maintained by an employer for lodging of his employees while in business travel status, or (c) an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. On the other
hand, the providing of a hotel room or an automobile by an employer to his employee who is on vacation would constitute entertainment of the employee.

(ii) **Objective test.** An objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments such as that entertainment means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer’s trade or business shall be considered. Thus, although attending a theatrical performance would generally be considered entertainment, it would not be so considered in the case of a professional theater critic, attending in his professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce his products to a group of store buyers, the show would not be generally considered to constitute entertainment. However, if an appliance distributor conducts a fashion show for the wives of his retailers, the fashion show would be generally considered to constitute entertainment.

(iii) **Special definitional rules—(a) In general.** Except as otherwise provided in (b) or (c) of this subdivision, any expenditure which might generally be considered either for a gift or entertainment, or considered either for travel or entertainment, shall be considered an expenditure for entertainment rather than for a gift or travel.

(b) **Expenditures deemed gifts.** An expenditure described in (a) of this subdivision shall be deemed for a gift to which this section does not apply if it is:

1. An expenditure for packaged food or beverages transferred directly or indirectly to another person intended for consumption at a later time.

2. An expenditure for tickets of admission to a place of entertainment transferred to another person if the taxpayer does not accompany the recipient to the entertainment unless the taxpayer treats the expenditure as entertainment. The taxpayer may change his treatment of such an expenditure as either a gift or entertainment at any time within the period prescribed for assessment of tax as provided in section 6501 of the Code and the regulations thereunder.

(3) Such other specific classes of expenditure generally considered to be for a gift as the Commissioner, in his discretion, may prescribe.

(c) **Expenditures deemed travel.** An expenditure described in (a) of this subdivision shall be deemed for travel to which this section does not apply if it is:

1. With respect to a transportation type facility (such as an automobile or an airplane), even though used on other occasions in connection with an activity of a type generally considered to constitute entertainment, to the extent the facility is used in pursuit of a trade or business for purposes of transportation not in connection with entertainment. See also paragraph (e)(3)(iii)(b) of this section for provisions covering nonentertainment expenditures with respect to such facilities.

2. Such other specific classes of expenditure generally considered to be for travel as the Commissioner, in his discretion, may prescribe.

(2) **Other definitions—(1) Expenditure.** For purposes of this section, any reference to trade or business shall include any activity described in section 212.

(ii) **Expenses for production of income.** The term expenditure as used in this section shall include expenses paid or incurred for goods, services, facilities, and items (including items such as losses and depreciation).

(iii) **Business associate.** The term business associate as used in this section means a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer’s trade or business such...
as the taxpayer’s customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.

(c) Directly related entertainment—(1) In general. Except as otherwise provided in paragraph (d) of this section (relating to associated entertainment) or under paragraph (f) of this section (relating to business meals and other specific exceptions), no deduction shall be allowed for any expenditure for entertainment unless the taxpayer establishes that the expenditure was directly related to the active conduct of his trade or business within the meaning of this paragraph.

(2) Directly related entertainment defined. Any expenditure for entertainment, if it is otherwise allowable as a deduction under chapter 1 of the Code, shall be considered directly related to the active conduct of the taxpayer’s trade or business if it meets the requirements of any one of subparagraphs (3), (4), (5), or (6) of this paragraph.

(3) Directly related in general. Except as provided in subparagraph (7) of this paragraph, an expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer’s trade or business if it meets all of the requirements of subdivisions (i), (ii), (iii) and (iv) of this subparagraph.

(i) At the time the taxpayer made the entertainment expenditure (or committed himself to make the expenditure), the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure. A taxpayer, however, shall not be required to show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed.

(ii) During the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining such income or other specific trade or business benefit (or, at

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the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that he would have done so, although such was not the case solely for reasons beyond the taxpayer’s control).

(iii) In light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer’s trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer’s control).

(iv) The expenditure was allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment or with whom the taxpayer establishes he would have engaged in such active conduct of trade or business if it were not for circumstances beyond the taxpayer’s control. For expenditures closely connected with directly related entertainment, see paragraph (d)(4) of this section.

(4) Expenditures in clear business setting. An expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer’s trade or business if it is established that the expenditure was for entertainment occurring in a clear business setting directly in furtherance of the taxpayer’s trade or business. Generally, entertainment shall not be considered to have occurred in a clear business setting unless the taxpayer clearly establishes that any recipient of the entertainment would have reasonably
known that the taxpayer had no significant motive, in incurring the expenditure, other than directly furthering his trade or business. Objective rather than subjective standards will be determinative. Thus, entertainment which occurred under any circumstances described in subparagraph (7)(ii) of this paragraph ordinarily will not be considered as occurring in a clear business setting. Such entertainment will generally be considered to be socially rather than commercially motivated. Expenditures made for the furtherance of a taxpayer’s trade or business in providing a “hospitality room” at a convention (described in paragraph (d)(3)(i)(b) of this section) at which goodwill is created through display or discussion of the taxpayer’s products, will, however, be treated as directly related. In addition, entertainment of a clear business nature which occurred under circumstances where there was no meaningful personal or social relationship between the taxpayer and the recipients of the entertainment may be considered to have occurred in a clear business setting. For example, entertainment of business representatives and civic leaders at the opening of a new hotel or theatrical production, where the clear purpose of the taxpayer is to obtain business publicity rather than to create or maintain the goodwill of the recipients of the entertainment, would generally be considered to be in a clear business setting. Also, entertainment which has the principal effect of a price rebate in connection with the sale of the taxpayer’s products generally will be considered to have occurred in a clear business setting. Such would be the case, for example, if a taxpayer owning a hotel were to provide occasional free dinners at the hotel for a customer who patronized the hotel.

(5) *Expenditures for services performed.* An expenditure shall be considered directly related to the active conduct of the taxpayer’s trade or business if it is established that the expenditure was made directly or indirectly by the taxpayer for the benefit of an individual (other than an employee), and if such expenditure was in the nature of compensation for services rendered or was paid as a prize or award which is required to be included in gross income under section 74 and the regulations thereunder. For example, if a manufacturer of products provides a vacation trip for retailers of his products who exceed sales quotas as a prize or award which is includible in gross income, the expenditure will be considered directly related to the active conduct of the taxpayer’s trade or business.

(6) *Club dues, etc., allocable to business meals.* An expenditure shall be considered directly related to the active conduct of the taxpayer’s trade or business if it is established that the expenditure was with respect to a facility (as described in paragraph (e) of this section) used by the taxpayer for the furnishing of food or beverages under circumstances described in paragraph (f)(2)(i) of this section (relating to business meals and similar expenditures), to the extent allocable to the furnishing of such food or beverages. This paragraph (c)(6) applies to club dues paid or incurred before January 1, 1987.

(7) *Expenditures generally considered not directly related.* Expenditures for entertainment, even if connected with the taxpayer’s trade or business, will generally be considered not directly related to the active conduct of the taxpayer’s trade or business if it is established that the expenditure occurred under circumstances where there was little or no possibility of engaging in the active conduct of trade or business. The following circumstances will generally be considered circumstances where there was little or no possibility of engaging in the active conduct of a trade or business:

(i) The taxpayer was not present;
(ii) The distractions were substantial, such as:
   (a) A meeting or discussion at night clubs, theaters, and sporting events, or during essentially social gatherings such as cocktail parties, or
   (b) A meeting or discussion, if the taxpayer meets with a group which includes persons other than business associates, at places such as cocktail lounges, country clubs, golf and athletic clubs, or at vacation resorts.

An expenditure for entertainment in any such case is considered not to be directly related to the active conduct
of the taxpayer's trade or business unless the taxpayer clearly establishes to the contrary.

(d) Associated entertainment—(1) In general. Except as provided in paragraph (f) of this section (relating to business meals and other specific exceptions) and subparagraph (4) of this paragraph (relating to expenditures closely connected with directly related entertainment), any expenditure for entertainment which is not directly related to the active conduct of the taxpayer's trade or business will not be allowable as a deduction unless:

(i) It was associated with the active conduct of trade or business as defined in subparagraph (2) of this paragraph, and

(ii) The entertainment directly preceded or followed a substantial and bona fide business discussion as defined in subparagraph (3) of this paragraph.

(2) Associated entertainment defined. Generally, any expenditure for entertainment, if it is otherwise allowable under Chapter 1 of the Code, shall be considered associated with the active conduct of the taxpayer's trade or business if the taxpayer establishes that he had a clear business purpose in making the expenditure, such as to obtain new business or to encourage the continuation of an existing business relationship. However, any portion of an expenditure allocable to a person who was not closely connected with a person who engaged in the substantial and bona fide business discussion shall not be considered associated with the active conduct of the taxpayer's trade or business. The portion of an expenditure allocable to the spouse of a person who engaged in the discussion will, if it is otherwise allowable under chapter 1 of the Code, be considered associated with the active conduct of the taxpayer's trade or business.

(3) Directly preceding or following a substantial and bona fide business discussion defined—(1) Substantial and bona fide business discussion—(a) In general. Whether any meeting, negotiation or discussion constitutes a "substantial and bona fide business discussion" within the meaning of this section depends upon the facts and circumstances of each case. It must be established, however, that the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining income or other specific trade or business benefit. In addition, it must be established that such a business meeting, negotiation, discussion, or transaction was substantial in relation to the entertainment. This requirement will be satisfied if the principal character or aspect of the combined entertainment and business activity was the active conduct of business. However, it is not necessary that more time be devoted to business than to entertainment to meet this requirement.

(b) Meetings at conventions, etc. Any meeting officially scheduled in connection with a program at a convention or similar general assembly, or at a bona fide trade or business meeting sponsored and conducted by business or professional organizations, shall be considered to constitute a substantial and bona fide business discussion within the meaning of this section provided:

(1) Expenses necessary to taxpayer's attendance. The expenses necessary to the attendance of the taxpayer at the convention, general assembly, or trade or business meeting, were ordinary and necessary within the meaning of section 162 or 212.

(2) Convention program. The organization which sponsored the convention, or trade or business meeting had scheduled a program of business activities (including committee meetings or presentation of lectures, panel discussions, display of products, or other similar activities), and that such program was the principal activity of the convention, general assembly, or trade or business meeting.

(ii) Directly preceding or following. Entertainment which occurs on the same day as a substantial and bona fide business discussion (as defined in subdivision (i) of this subparagraph) will be considered to directly precede or follow such discussion. If the entertainment and the business discussion do not occur on the same day, the facts and circumstances of each case are to be considered, including the place, date...
and duration of the business discussion, whether the taxpayer or his business associates are from out of town, and, if so, the date of arrival and departure, and the reasons the entertainment did not take place on the day of the business discussion. For example, if a group of business associates comes from out of town to the taxpayer’s place of business to hold a substantial business discussion, the entertainment of such business guests and their wives on the evening prior to, or on the evening of the day following, the business discussion would generally be regarded as directly preceding or following such discussion.

(4) Expenses closely connected with directly related entertainment. If any portion of an expenditure meets the requirements of paragraph (c)(3) of this section (relating to directly related entertainment in general), the remaining portion of the expenditure, if it is otherwise allowable under Chapter 1 of the Code, shall be considered associated with the active conduct of the taxpayer’s trade or business to the extent allocable to a person or persons closely connected with a person referred to in paragraph (c)(3)(iv) of this section. The spouse of a person referred to in paragraph (c)(3)(iv) of this section will be considered closely connected to such a person for purposes of this subparagraph. Thus, if a taxpayer and his wife entertain a business customer and the customer’s wife under circumstances where the entertainment of the customer is considered directly related to the active conduct of the taxpayer’s trade or business (within the meaning of paragraph (c)(3) of this section) the portion of the expenditure allocable to both wives will be considered associated with the active conduct of the taxpayer’s trade or business under this subparagraph.

(e) Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs—(1) In general. Any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred before January 1, 1994, with respect to a club, used in connection with entertainment shall not be allowed as a deduction except to the extent it meets the requirements of paragraph (a)(2)(ii) of this section.

(2) Facilities used in connection with entertainment—(i) In general. Any item of personal or real property owned, rented, or used by a taxpayer shall (unless otherwise provided under the rules of subdivision (ii) of this subparagraph) be considered to constitute a facility used in connection with entertainment if it is used during the taxable year for, or in connection with, entertainment (as defined in paragraph (b)(1) of this section). Examples of facilities which might be used for, or in connection with, entertainment include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suites, and homes in vacation resorts.

(ii) Facilities used incidentally for entertainment. A facility used only incidentally during a taxable year in connection with entertainment, if such use is insubstantial, will not be considered a “facility used in connection with entertainment” for purposes of this section or for purposes of the recordkeeping requirements of section 274(d). See §1.274–5(c)(6)(iii).

(3) Expenditures with respect to a facility used in connection with entertainment—(i) In general. The phrase expenditures with respect to a facility used in connection with entertainment includes depreciation and operating costs, such as rent and utility charges (for example, water or electricity), expenses for the maintenance, preservation or protection of a facility (for example, repairs, painting, insurance charges), and salaries or expenses for subsistence paid to caretakers or watchmen. In addition, the phrase includes losses realized on the sale or other disposition of a facility.

(ii) Club dues—(a) Club dues paid or incurred before January 1, 1994. Dues or fees paid before January 1, 1994, to any social, athletic, or sporting club or organization are considered expenditures with respect to a facility used in connection with entertainment. The purposes and activities of a club or organization, and not its name, determine its character. Generally, the phrase social, athletic, or sporting club or organization has the same meaning for purposes of
this section as that phrase had in section 4241 and the regulations thereunder, relating to the excise tax on club dues, prior to the repeal of section 4241 by section 301 of Public Law 89–44. However, for purposes of this section only, clubs operated solely to provide lunches under circumstances of a type generally considered to be conducive to business discussion, within the meaning of paragraph (f)(2)(i) of this section, will not be considered social clubs.

(b) Club dues paid or incurred after December 31, 1993. See paragraph (a)(2)(iii) of this section with reference to the disallowance of deductions for club dues paid or incurred after December 31, 1993.

(iii) Expenditures not with respect to a facility. The following expenditures shall not be considered to constitute expenditures with respect to a facility used in connection with entertainment:

(a) Out of pocket expenditures. Expenses (exclusive of operating costs and other expenses referred to in subdivision (i) of this subparagraph) incurred at the time of an entertainment activity, even though in connection with the use of facility for entertainment purposes, such as expenses for food and beverages, or expenses for catering, or expenses for gasoline and fishing bait consumed on a fishing trip;

(b) Non-entertainment expenditures. Expenses or items attributable to the use of a facility for other than entertainment purposes such as expenses for an automobile when not used for entertainment; and

(c) Expenditures otherwise deductible. Expenses allowable as a deduction without regard to their connection with a taxpayer’s trade or business such as taxes, interest, and casualty losses. The provisions of this subdivision shall be applied in the case of a taxpayer which is not an individual as if it were an individual. See also §1.274–6.

(iv) Cross reference. For other rules with respect to treatment of certain expenditures for entertainment-type facilities, see §1.274–7.

(A) Determination of primary use—(i) In general. A facility used in connection with entertainment shall be considered as used primarily for the furtherance of the taxpayer’s trade or business only if it is established that the primary use of the facility during the taxable year was for purposes considered ordinary and necessary within the meaning of sections 162 and 212 and the regulations thereunder. All of the facts and circumstances of each case shall be considered in determining the primary use of a facility. Generally, it is the actual use of the facility which establishes the deductibility of expenditures with respect to the facility; not its availability for use and not the taxpayer’s principal purpose in acquiring the facility. Objective rather than subjective standards will be determinative. If membership entitles the member’s entire family to use of a facility, such as a country club, their use will be considered in determining whether business use of the facility exceeds personal use. The factors to be considered include the nature of each use, the frequency and duration of use for business purposes as compared with other purposes, and the amount of expenditures incurred during use for business compared with amount of expenditures incurred during use for other purposes.

(ii) Certain transportation facilities. A taxpayer shall be deemed to have established that a facility was used primarily for the furtherance of his trade or business if he establishes such primary use in accordance with subdivision (ii) or (iii) of this subparagraph. Subdivisions (ii) and (iii) of this subparagraph shall not preclude a taxpayer from otherwise establishing the primary use of a facility under the general provisions of this subdivision.

(A) Automobiles. In the case of an automobile, the taxpayer establishes that more than 50 percent of mileage
driven during the taxable year was in connection with travel considered to be ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder.

(b) Airplanes. In the case of an airplane, the taxpayer establishes that more than 50 percent of hours flown during the taxable year was in connection with travel considered to be ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder.

(iii) Entertainment facilities in general. A taxpayer shall be deemed to have established that:

(a) A facility used in connection with entertainment, such as a yacht or other pleasure boat, hunting lodge, fishing camp, summer home or vacation cottage, hotel suite, country club, golf club or similar social, athletic, or sporting club or organization, bowling alley, tennis court, or swimming pool, or,

(b) A facility for employees not falling within the scope of section 274(e) (2) or (5) was used primarily for the furtherance of his trade or business if he establishes that more than 50 percent of the total calendar days of use of the facility by, or under authority of, the taxpayer during the taxable year were days of business use. Any use of a facility (of a type described in this subdivision) during one calendar day shall be considered to constitute a “day of business use” if the primary use of the facility on such day was ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder. For the purposes of this subdivision, a facility shall be deemed to have been primarily used for such purposes on any one calendar day if the facility was used for the conduct of a substantial and bona fide business discussion (as defined in paragraph (d)(3)(i) of this section) notwithstanding that the facility may also have been used on the same day for personal or family use by the taxpayer or any member of the taxpayer’s family not involving entertainment of others by, or under the authority of, the taxpayer.

(f) Specific exceptions to application of this section—(1) In general. The provisions of paragraphs (a) through (e) of this section (imposing limitations on deductions for entertainment expenses) are not applicable in the case of expenditures set forth in subparagraph (2) of this paragraph. Such expenditures are deductible to the extent allowable under chapter 1 of the Code. This paragraph shall not be construed to affect the allowability or nonallowability of a deduction under section 162 or 212 and the regulations thereunder.

(2) Exceptions. The expenditures referred to in subparagraph (1) of this paragraph are set forth in subdivisions (i) through (ix) of this subparagraph.

(i) Business meals and similar expenditures paid or incurred before January 1, 1987—(a) In general. Any expenditure for food or beverages furnished to an individual under circumstances of a type generally considered conducive to business discussion (taking into account the surroundings in which furnished, the taxpayer’s trade, business, or income-producing activity, and the relationship to such trade, business or activity of the persons to whom the food or beverages are furnished) is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. There is no requirement that business actually be discussed for this exception to apply.

(b) Surroundings. The surroundings in which the food or beverages are furnished must be such as would provide an atmosphere where there are no substantial distractions to discussion. This exception applies primarily to expenditures for meals and beverages served during the course of a breakfast, lunch or dinner meeting of the taxpayer and his business associates at a restaurant, hotel dining room, eating club or similar place not involving distracting influences such as a floor
show. This exception also applies to expenditures for beverages served apart from meals if the expenditure is incurred in surroundings similarly conducive to business discussion, such as an expenditure for beverages served during the meeting of the taxpayer and his business associates at a cocktail lounge or hotel bar not involving distracting influences such as a floor show. This exception may also apply to expenditures for meals or beverages served in the taxpayer’s residence on a clear showing that the expenditure was commercially rather than socially motivated. However, this exception, generally, is not applicable to any expenditure for meals or beverages furnished in circumstances where there are major distractions not conducive to business discussion, such as at night clubs, sporting events, large cocktail parties, sizeable social gatherings, or other major distracting influences.

(c) Taxpayer’s trade or business and relationship of persons entertained. The taxpayer’s trade, business, or income-producing activity and the relationship of the persons to whom the food or beverages are served to such trade, business or activity must be such as will reasonably indicate that the food or beverages were furnished for the primary purpose of furthering the taxpayer’s trade or business and did not primarily serve a social or personal purpose. Such a business purpose would be indicated, for example, if a salesman employed by a manufacturing supply company meets for lunch during a normal business day with a purchasing agent for a manufacturer which is a prospective customer. Such a purpose would also be indicated if a life insurance agent meets for lunch during a normal business day with a client.

(d) Business programs. Expenditures for business luncheons or dinners which are part of a business program, or banquets officially sponsored by business or professional associations, will be regarded as expenditures to which the exception of this subdivision (i) applies. In the case of such a business luncheon or dinner it is not always necessary that the taxpayer attend the luncheon or dinner himself. For example, if a dental equipment supplier purchased a table at a dental association banquet for dentists who are actual or prospective customers for his equipment, the cost of the table would not be disallowed under this section. See also paragraph (c)(4) of this section relating to expenditures made in a clear business setting.

(ii) Food and beverages for employees. Any expenditure by a taxpayer for food and beverages (or for use of a facility in connection therewith) furnished on the taxpayer’s business premises primarily for his employees is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. This exception applies not only to expenditures for food or beverages furnished in a typical company cafeteria or an executive dining room, but also to expenditures with respect to the operation of such facilities. This exception applies even though guests are occasionally served in the cafeteria or dining room.

(iii) Certain entertainment and travel expenses treated as compensation.—(A) In general. Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) or for travel described in section 274(m)(3), if an employee is the recipient of the entertainment or travel, is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent that the expenditure is treated by the taxpayer—

(1) On the taxpayer’s income tax return as originally filed, as compensation paid to the employee; and

(2) As wages to the employee for purposes of withholding under chapter 24 (relating to collection of income tax at source on wages).

(B) Expenses includible in income of persons who are not employees. Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith), or for travel described in section 274(m)(3), is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent the expenditure is includible in gross income as compensation for services rendered, or as a prize or award under section 74, by a recipient of the expenditure who is not an employee of the taxpayer. The preceding sentence
shall not apply to any amount paid or incurred by the taxpayer if such amount is required to be included (or would be so required except that the amount is less that $600) in any information return filed by such taxpayer under part III of subchapter A of chapter 61 and is not so included. See section 274(e)(9).

(C) Example. The following example illustrates the provisions this paragraph (f):

Example. If an employer rewards the employee (and the employee’s spouse) with an extended vacation trip, the expense is deductible by the employer (if otherwise allowable under section 162 and the regulations thereunder) to the extent the employer treats the expenses as compensation and as wages. On the other hand, if a taxpayer owns a yacht which the taxpayer uses for the entertainment of business customers, the portion of salary paid to employee members of the crew which is allocable to use of the yacht for entertainment purposes (even though treated on the taxpayer’s tax return as compensation and treated as wages for withholding tax purposes) would not come within this exception since the members of the crew were not recipients of the entertainment. If an expenditure of a type described in this subdivision properly constitutes a dividend paid to a shareholder, unreasonable compensation paid to an employee, or a personal, living or family expense, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Code.

(iv) Reimbursement arrangements between employee and employer. In the case of an expenditure for entertainment paid or incurred by an employee under a reimbursement or other expense allowance arrangement with his employer, the limitations on deductions provided for in paragraphs (a) through (e) of this section shall not apply:

(1) Employees. To the employee except to the extent his employer has treated the expenditure on the employer’s income tax return as originally filed as compensation paid to the employee and as wages to such employee for purposes of withholding tax at source on wages.

(2) Employers. To the employer to the extent he has treated the expenditure as compensation and wages paid to an employee in the manner provided in (b)(1) of this subdivision.

(c) Reimbursement arrangements between independent contractors and clients or customers. In the case of an expenditure for entertainment paid or incurred by one person (hereinafter termed “independent contractor”) under a reimbursement or other expense allowance arrangement with another person other than an employer (hereinafter termed “client or customer”), the limitations on deductions provided for in paragraphs (a) through (e) of this section shall not apply:

(1) Independent contractors. To the independent contractor to the extent he accounts to his client or customer within the meaning of section 274(d) and the regulations thereunder. See §1.274–5.

(2) Clients or customers. To the client or customer if the expenditure is disallowed to the independent contractor under paragraphs (a) through (e) of this section.

(v) Recreational expenses for employees generally. Any expenditure by a taxpayer for a recreational, social, or
similar activity (or for use of a facility in connection therewith), primarily for the benefit of his employees generally, is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. This exception applies only to expenditures made primarily for the benefit of employees of the taxpayer other than employees who are officers, shareholders on other owners who own a 10 percent or greater interest in the business, or other highly compensated employees. For purposes of the preceding sentence, an employee shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(4) and the regulations thereunder). Ordinarily, this exception applies to usual employee benefit programs such as expenses of a taxpayer (a) in holding Christmas parties, annual picnics, or summer outings, for his employees generally, or (b) of maintaining a swimming pool, baseball diamond, bowling alley, or golf course available to his employees generally. Any expenditure for an activity which is made under circumstances which discriminate in favor of employees who are officers, shareholders or other owners, or highly compensated employees shall not be considered made primarily for the benefit of employees generally. On the other hand, an expenditure for an activity which is intended to be engaged in by officers, shareholders or other owners, or highly compensated employees shall not be considered made primarily for the benefit of employees generally. The exception will not apply to meetings or conventions at which the principal purpose is to reward employees for their services to the taxpayer. However, such a meeting or convention of employees might come within the scope of subdivisions (iii) or (v) of this subparagraph.

(vi) Employee, stockholder, etc., business meetings. Any expenditure by a taxpayer for entertainment which is directly related and necessary to attendance at bona fide business meetings or conventions of organizations exempt from taxation under section 501(c)(6) of the Code, such as business leagues, chambers of commerce, real estate boards, boards of trade, and certain professional associations, is not subject to the limitations on allowability of deductions provided in paragraphs (a) through (e) of this section.

(viii) Items available to the public. Any expenditure by a taxpayer for entertainment (or for a facility in connection therewith) to the extent the entertainment is made available to the general public is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. Expenditures for entertainment of the general public by
means of television, radio, newspapers and the like, will come within this exception, as will expenditures for distributing samples to the general public. Similarly, expenditures for maintaining private parks, golf courses and similar facilities, to the extent that they are available for public use, will come within this exception. For example, if a corporation maintains a swimming pool which makes it available for a period of time each week to children participating in a local public recreational program, the portion of the expense relating to such public use of the pool will come within this exception. For example, if a corporation maintains a swimming pool which makes it available for a period of time each week to children participating in a local public recreational program, the portion of the expense relating to such public use of the pool will come within this exception.

(ix) Entertainment sold to customers. Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) to the extent the entertainment is sold to customers in a bona fide transaction for an adequate and full consideration in money or money’s worth is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. Thus, the cost of producing night club entertainment (such as salaries paid to employees of night clubs and amounts paid to performers) for sale to customers or the cost of operating a pleasure cruise ship as a business will come within this exception.

(g) Additional provisions of section 274—travel of spouse, dependent or others. Section 274(m)(3) provides that no deduction shall be allowed under this chapter (except section 217) for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel, unless certain conditions are met. As provided in section 274(m)(3), the term other individual does not include a business associate (as defined in paragraph (b)(2)(i)(i) of this section) who otherwise meets the requirements of sections 274(m)(3)(B) and (C).

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(iv) In the case of a taxable year of a taxpayer ending before August 13, 1981, an item of tangible personal property having a cost to the taxpayer not in excess of $100 which is awarded to an employee of the taxpayer by reason of the employee’s length of service (including an award upon retirement) or safety achievement.

For purposes of paragraphs (b)(2)(iii) and (iv) of this section, the term tangible personal property does not include cash or any gift certificate other than a nonnegotiable gift certificate conferring only the right to receive tangible personal property. Thus, for example, if a nonnegotiable gift certificate entitles an employee to choose between selecting an item of merchandise or receiving cash or reducing the balance due on his account with the issuer of the gift certificate, the gift certificate is not tangible personal property for purposes of this section. To the extent that an item is not treated as a gift for purposes of this section, the deductibility of the expense of the item is not governed by this section, and the taxpayer need not take such item into account in determining whether the $25 limitation on gifts to any individual has been exceeded. For example, if an employee receives by reason of his length of service a gift of an item of tangible personal property that costs the employer $450, the deductibility of only $50 ($450 minus $400) is governed by this section, and the employer takes the $50 into account for purposes of the $25 limitation on gifts to that employee. The fact that an item is wholly or partially excepted from the applicability of this section has no effect in determining whether the value of the item is includible in the gross income of the recipient. For rules relating to the taxability to the recipient of any item described in this subparagraph, see sections 61, 74, and 102 and the regulations thereunder. For rules relating to the deductibility of employee achievement awards awarded after December 31, 1986, see section 274(j).

(c) Expense for a gift. For purposes of this section, the term expense for a gift means the cost of the gift to the taxpayer, other than incidental costs such as for customary engraving on jewelry, or for packaging, insurance, and mailing or other delivery. A related cost will be considered “incidental” only if it does not add substantial value to the gift. Although the cost of customary gift wrapping will be considered an incidental cost, the purchase of an ornamental basket for packaging fruit will not be considered an incidental cost of packaging if the basket has a value which is substantial in relation to the value of the fruit.

(d) Qualified plan award—(1) In general. Except as provided in subparagraph (2) of this paragraph the term qualified plan award, for purposes of this section, means an item of tangible personal property that is awarded to an employee by reason of the employee’s length of service (including retirement), productivity, or safety achievement, and that is awarded pursuant to a permanent, written award plan or program of the taxpayer that does not discriminate as to eligibility or benefits in favor of employees who are officers, shareholders, or highly compensated employees. The “permanency” of an award plan shall be determined from all the facts and circumstances of the particular case, including the taxpayer’s ability to continue to make the awards as required by the award plan. Although the taxpayer may reserve the right to change or to terminate an award plan, the actual termination of the award plan for any reason other than business necessity within a few years after it has taken effect may be evidence that the award plan from its inception was not a “permanent” award plan. Whether or not an award plan is discriminatory shall be determined from all the facts and circumstances of the particular case. An award plan may fail to qualify because it is discriminatory in its actual operation even though the written provisions of the award plan are not discriminatory.

(2) Items not treated as qualified plan awards. The term qualified plan award, for purposes of this section, does not include an item qualifying under paragraph (d)(1) of this section if the average cost of all items (whether or
(d) During the taxable year by the taxpayer under any plan described in paragraph (d)(1) of this section exceeds $400. The average cost of those items shall be computed by dividing (i) the sum of the costs for those items (including amounts in excess of the $1,600 limitation) by (ii) the total number of those items.

(e) Gifts made indirectly to an individual—(1) Gift to spouse or member of family. If a taxpayer makes a gift to the wife of a man who has a business connection with the taxpayer, the gift generally will be considered as made indirectly to the husband. However, if the wife has a bona fide business connection with the taxpayer independently of her relationship to her husband, a gift to her generally will not be considered as made indirectly to her husband unless the gift is intended for his eventual use or benefit. Thus, if a taxpayer makes a gift to a wife who is engaged with her husband in the active conduct of a partnership business, the gift to the wife will not be considered an indirect gift to her husband unless it is intended for his eventual use or benefit. The same rules apply to gifts to any other member of the family of an individual who has a business connection with the taxpayer.

(2) Gift to corporation or other business entity. If a taxpayer makes a gift to a corporation or other business entity intended for the eventual personal use or benefit of an individual who is an employee, stockholder, or other owner of the corporation or business entity, the gift generally will be considered as made indirectly to such individual. Thus, if a taxpayer provides theater tickets to a closely held corporation for the eventual use by any one of the stockholders of the corporation, and if such tickets are gifts, the gifts will be considered as made indirectly to the individual who eventually uses such ticket. On the other hand, a gift to a business organization of property to be used in connection with the business of the organization (for example, a technical manual) will not be considered as a gift to an individual, even though, in practice, the book will be used principally by a readily identifiable individual employee. A gift for the eventual personal use or benefit of some undesignated member of a large group of individuals generally will not be considered as made indirectly to the individual who eventually uses, or benefits from, such gifts unless, under the circumstances of the case, it is reasonably practicable for the taxpayer to ascertain the ultimate recipient of the gift. Thus, if a taxpayer provides several baseball tickets to a corporation for the eventual use by any one of a large number of employees or customers of the corporation, and if such tickets are gifts, the gifts generally will not be treated as made indirectly to the individuals who use such tickets.

(f) Special rules—(1) Partnership. In the case of a gift by a partnership, the $25 annual limitation contained in paragraph (a) of this section shall apply to the partnership as well as to each member of the partnership. Thus, in the case of a gift made by a partner with respect to the business of the partnership, the $25 limitation will be applied at the partnership level as well as at the level of the individual partner. Consequently, deductions for gifts made with respect to partnership business will not exceed $25 annually for each recipient, regardless of the number of partners.

(2) Husband and wife. For purposes of applying the $25 annual limitation contained in paragraph (a) of this section, a husband and wife shall be treated as one taxpayer. Thus, in the case of gifts to an individual by a husband and wife, the spouses will be treated as one donor; and they are limited to a deduction of $25 annually for each recipient, regardless of whether the husband and wife file a joint return or whether the husband and wife make separate gifts to an individual with respect to separate businesses. Since the term taxpayer in paragraph (a) of this section refers only to the donor of a gift, this special rule does not apply to treat a husband and wife as one individual where each is a recipient of a gift. See paragraph (e)(1) of this section.
§ 1.274–4 Disallowance of certain foreign travel expenses.

(a) Introductory. Section 274(c) and this section impose certain restrictions on the deductibility of travel expenses incurred in the case of an individual who, while traveling outside the United States away from home in the pursuit of trade or business (hereinafter termed “business activity”), engages in substantial personal activity not attributable to such trade or business (hereinafter termed “nonbusiness activity”). Section 274(c) and this section are limited in their application to individuals (whether or not an employee or other person traveling under a reimbursement or other expense allowance arrangement) who engage in nonbusiness activity while traveling outside the United States away from home, and do not impose restrictions on the deductibility of travel expenses incurred by an employer or client under an advance, reimbursement, or other arrangement with the individual who engages in nonbusiness activity. For purposes of this section, the term United States includes only the States and the District of Columbia, and any reference to “trade or business” or “business activity” includes any activity described in section 212. For purposes of this section, 1 week means 7 consecutive days. The day in which travel outside the United States away from home begins shall not be considered, but the day in which such travel ends shall be considered, in determining whether a taxpayer is outside the United States away from home for more than 7 consecutive days. For example, if a taxpayer departs on travel outside the United States away from home on a Wednesday morning and ends such travel the following Wednesday evening, he shall be considered as being outside the United States away from home only 7 consecutive days. In such a case, this section would not apply because the taxpayer was not outside the United States away from home for more than 7 consecutive days. However, if the taxpayer travels outside the United States away from home for more than 7 consecutive days, both the day such travel begins and the day such travel ends shall be considered a “business day” or a “nonbusiness day”, as the case may be, for purposes of determining whether nonbusiness activity constituted 25 percent or more of travel time under paragraph (d) of this section and for purposes of allocating expenses under paragraph (f) of this section. For purposes of determining whether travel is outside the United States away from home, see paragraph (e) of this section.

(b) Limitations on application of section. The restrictions on deductibility of travel expenses contained in paragraph (f) of this section are applicable only if:

(1) The travel expense is otherwise deductible under section 162 or 212 and the regulations thereunder,

(2) The travel expense is for travel outside the United States away from home which exceeds 1 week (as determined under paragraph (c) of this section), and

(3) The time outside the United States away from home attributable to nonbusiness activity (as determined under paragraph (d) of this section) constitutes 25 percent or more of the total time on such travel.

(c) Travel in excess of 1 week. This section does not apply to an expense of travel unless the expense is for travel outside the United States away from home which exceeds 1 week. For purposes of this section, 1 week means 7 consecutive days. The day in which travel outside the United States away from home begins shall not be considered, but the day in which such travel ends shall be considered, in determining whether a taxpayer is outside the United States away from home for more than 7 consecutive days. For example, if a taxpayer departs on travel outside the United States away from home on a Wednesday morning and ends such travel the following Wednesday evening, he shall be considered as being outside the United States away from home only 7 consecutive days. In such a case, this section would not apply because the taxpayer was not outside the United States away from home for more than 7 consecutive days. However, if the taxpayer travels outside the United States away from home for more than 7 consecutive days, both the day such travel begins and the day such travel ends shall be considered a “business day” or a “nonbusiness day”, as the case may be, for purposes of determining whether nonbusiness activity constituted 25 percent or more of travel time under paragraph (d) of this section and for purposes of allocating expenses under paragraph (f) of this section. For purposes of determining whether travel is outside the United States away from home, see paragraph (e) of this section.

(d) Nonbusiness activity constituting 25 percent or more of travel time—(1) In general. This section does not apply to any expense of travel outside the United States away from home unless the portion of time outside the United States away from home attributable to nonbusiness activity constitutes 25 percent or more of the total time on such travel.

(2) Allocation on per day basis. The total time traveling outside the United
States away from home will be allocated on a day-by-day basis to (i) days of business activity or (ii) days of nonbusiness activity (hereinafter termed “business days” or “nonbusiness days” respectively) unless the taxpayer establishes that a different method of allocation more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity. For purposes of this section, a day spent outside the United States away from home shall be deemed entirely a business day even though spent only in part on business activity if the taxpayer establishes:

(i) Transportation days. That on such day the taxpayer was traveling to or returning from a destination outside the United States away from home in the pursuit of trade or business. However, if for purposes of engaging in nonbusiness activity, the taxpayer while traveling outside the United States away from home does not travel by a reasonably direct route, only that number of days shall be considered business days as would have been required for the taxpayer to drive by a reasonably direct route to Quebec, taking into account normal periods for rest and meals.

(ii) Presence required. That on such day his presence outside the United States away from home was required at a particular place for a specific and bona fide business purpose. For example, if a taxpayer is instructed by his employer to attend a specific business meeting, the day of the meeting shall be considered a business day even though, because of the scheduled length of the meeting, the taxpayer spends more time during normal working hours of the day on nonbusiness activity than on business activity.

(iii) Days primarily business. That during hours normally considered to be appropriate for business activity, his principal activity on such day was the pursuit of trade or business.

(iv) Circumstances beyond control. That on such day he was prevented from engaging in the conduct of trade or business as his principal activity due to circumstances beyond his control.

(v) Weekends, holidays, etc. That such day was a Saturday, Sunday, legal holiday, or other reasonably necessary standby day which intervened during that course of the taxpayer's trade or business while outside the United States away from home which the taxpayer endeavored to conduct with reasonable dispatch. For example, if a taxpayer travels from New York to London to take part in business negotiations beginning on a Wednesday and concluding on the following Tuesday, the intervening Saturday and Sunday shall be considered business days whether or not business is conducted on either of such days. Similarly, if in the above case the meetings which concluded on Tuesday evening were followed by business meetings with another business group in London on the immediately succeeding Thursday and Friday, the intervening Wednesday will be deemed a business day. However, if at the conclusion of the business meetings on Friday, the taxpayer stays in London for an additional week for personal purposes, the Saturday and Sunday following the conclusion of the
business meeting will not be considered business days.

(e) Domestic travel excluded—(1) In general. For purposes of this section, travel outside the United States away from home does not include any travel from one point in the United States to another point in the United States. However, travel which is not from one point in the United States to another point in the United States shall be considered travel outside the United States. If a taxpayer travels from a place within the United States to a place outside the United States, the portion, if any, of such travel which is from one point in the United States to another point in the United States is to be disregarded for purposes of determining:

(i) Whether the taxpayer’s travel outside the United States away from home exceeds 1 week (see paragraph (c) of this section),

(ii) Whether the time outside the United States attributable to nonbusiness activity constitutes 25 percent or more of the total time on such travel (see paragraph (d) of this section), or

(iii) The amount of travel expense subject to the allocation rules of this section (see paragraph (f) of this section).

(2) Determination of travel from one point in the United States to another point in the United States. In the case of the following means of transportation, travel from one point in the United States to another point in the United States shall be determined as follows:

(i) Travel by public transportation. In the case of travel by public transportation, any place in the United States at which the vehicle makes a scheduled stop for the purpose of adding or discharging passengers shall be considered a point in the United States.

(ii) Travel by private automobile. In the case of travel by private automobile, any such travel which is within the United States shall be considered travel from one point in the United States to another point in the United States.

(iii) Travel by private airplane. In the case of travel by private airplane, any flight, whether or not constituting the entire trip, where both the takeoff and the landing are within the United States shall be considered travel from one point in the United States to another point in the United States.

(3) Examples. The provisions of subparagraph (2) may be illustrated by the following examples:

Example 1. Taxpayer A flies from Los Angeles to Puerto Rico with a brief scheduled stopover in Miami for the purpose of adding and discharging passengers and A returns by airplane nonstop to Los Angeles. The travel from Los Angeles to Miami is considered travel from one point in the United States to another point in the United States. The travel from Miami to Puerto Rico and from Puerto Rico to Los Angeles is not considered travel from one point in the United States to another point in the United States and, thus, is considered to be travel outside the United States away from home.

Example 2. Taxpayer B travels by train from New York to Montreal. The travel from New York to the last place in the United States where the train is stopped for the purpose of adding or discharging passengers is considered to be travel from one point in the United States to another point in the United States.

Example 3. Taxpayer C travels by automobile from Tulsa to Mexico City and back. All travel in the United States is considered to be travel from one point in the United States to another point in the United States.

Example 4. Taxpayer D flies nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel from one point in the United States to another point in the United States.

Example 5. If in Example 4 above, the airplane makes a scheduled landing in Vancouver, the time spent in traveling from Seattle to Juneau is considered to be travel outside the United States away from home. However, the time spent in Juneau is not considered to be travel outside the United States away from home.

(f) Application of disallowance rules—(1) In general. In the case of expense for travel outside the United States away from home by an individual to which this section applies, except as otherwise provided in subparagraph (4) or (5) of this paragraph, no deduction shall be allowed for that amount of travel expense specified in subparagraph (2) or (3) of this paragraph (whichever is applicable) which is obtained by multiplying the total of such travel expense by a fraction:

(i) The numerator of which is the number of nonbusiness days during such travel, and

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(ii) The denominator of which is the total number of business days and nonbusiness days during such travel.

For determination of “business days” and “nonbusiness days”, see paragraph (d)(2) of this section.

(2) Nonbusiness activity at, near, or beyond business destination. If the place at which the individual engages in nonbusiness activity (hereinafter termed “nonbusiness destination”) is at, near, or beyond the place to which he travels in the pursuit of a trade or business (hereinafter termed “business destination”), the amount of travel expense referred to in subparagraph (1) of this paragraph shall be the amount of travel expense, otherwise allowable as a deduction under section 162 or section 212, which would have been incurred in traveling from the place where travel outside the United States away from home begins to the business destination, and returning. Thus, if the individual travels from New York to London on business, and then takes a vacation in Paris before returning to New York, the amount of the travel expense subject to allocation is the expense which would have been incurred in traveling from New York to London and returning.

(3) Nonbusiness activity on the route to or from business destination. If the nonbusiness destination is on the route to or from the business destination, the amount of the travel expense referred to in subparagraph (1) of this paragraph shall be the amount of travel expense, otherwise allowable as a deduction under section 162 or 212, which would have been incurred in traveling from the place where travel outside the United States away from home begins to the nonbusiness destination and returning. Thus, if the individual travels on business from Chicago to Rio de Janeiro, Brazil with a scheduled stop in New York for the purpose of adding and discharging passengers, and while en route stops in Caracas, Venezuela for a vacation and returns to Chicago from Rio de Janeiro with another scheduled stop in New York for the purpose of adding and discharging passengers, the amount of travel expense subject to allocation is the expense which would have been incurred in traveling from New York to Caracas and returning.

(4) Other allocation method. If a taxpayer establishes that a method other than allocation on a day-by-day basis (as determined under paragraph (d)(2) of this section) more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity, the amount of travel expense for which no deduction shall be allowed shall be determined by such other method.

(5) Travel expense deemed entirely allocable to business activity. Expenses of travel shall be considered allocable in full to business activity, and no portion of such expense shall be subject to disallowance under this section, if incurred under circumstances provided for in subdivision (i) or (ii) of this subparagraph.

(i) Lack of control over travel. Expenses of travel otherwise deductible under section 162 or 212 shall be considered fully allocable to business activity if, considering all the facts and circumstances, the individual incurring such expenses did not have substantial control over the arranging of the business trip. A person who is required to travel to a business destination will not be considered to have substantial control over the arranging of the business trip merely because he has control over the timing of the trip. Any individual who travels on behalf of his employer under a reimbursement or other expense allowance arrangement shall be considered not to have had substantial control over the arranging of his business trip, provided the employee is not:

(a) A managing executive of the employer for whom he is traveling (and for this purpose the term managing executive includes only an employee who, by reason of his authority and responsibility, is authorized, without effective veto procedures, to decide upon the necessity for his business trip), or

(b) Related to his employer within the meaning of section 267(b) but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent.

(ii) Lack of major consideration to obtain a vacation. Any expense of travel, which qualifies for deduction under section 162 or 212, shall be considered fully allocable to business activity if the individual incurring such expenses
can establish that, considering all the facts and circumstances, he did not have a major consideration, in determining to make the trip, of obtaining a personal vacation or holiday. If such a major consideration were present, the provisions of subparagraphs (1) through (4) of this paragraph shall apply. However, if the trip were primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. See paragraph (b) of § 1.162–2.

(g) Examples. The application of this section may be illustrated by the following examples:

Example 1. Individual A flew from New York to Paris where he conducted business for 1 day. He spent the next 2 days sightseeing in Paris and then flew back to New York. The entire trip, including 2 days for travel en route, took 5 days. Since the time outside the United States away from home during the trip did not exceed 1 week, the disallowance rules of this section do not apply.

Example 2. Individual B flew from Tampa to Honolulu (from one point in the United States to another point in the United States) for a business meeting which lasted 3 days and for personal matters which took 10 days. He then flew to Melbourne, Australia where he conducted business for 2 days and went sightseeing for 1 day. Immediately thereafter he flew back to Tampa, with a scheduled landing in Honolulu for the purpose of adding and discharging passengers. Although the trip exceeded 1 week, the time spent outside the United States away from home, including 2 days for traveling from Honolulu to Melbourne and return, was 5 days. Since the time outside the United States away from home during the trip did not exceed 1 week, the disallowance rules of this section do not apply.

Example 3. Individual C flew from Los Angeles to New York where he spent 5 days. He then flew to Brussels where he spent 14 days on business and 5 days on personal matters. He then flew back to Los Angeles by way of New York. The entire trip, including 4 days for travel en route, took 28 days. However, the 2 days spent traveling from Los Angeles to New York and return, and the 5 days spent in New York are not considered travel outside the United States away from home and, thus, are disregarded for purposes of this section. Although the time spent outside the United States away from home exceeded 1 week, the time outside the United States away from home attributable to nonbusiness activities (5 days out of 21) was less than 25 percent of the total time outside the United States away from home during the trip. Therefore, the disallowance rules of this section do not apply.

Example 4. D, an employee of Y Company, who is neither a managing executive of, nor related to, Y Company within the meaning of paragraph (f)(5)(i) of this section, traveled outside the United States away from home on behalf of his employer and was reimbursed by Y for his traveling expense to and from the business destination. The trip took more than a week and D took advantage of the opportunity to enjoy a personal vacation which exceeded 25 percent of the total time on the trip. Since D, traveling under a reimbursement arrangement, is not a managing executive of, or related to, Y Company, he is not considered to have substantial control over the arranging of the trip or that a major consideration in determining to make the trip was not to provide an opportunity for taking a personal vacation, the entire travel expense to and from Stockholm shall be considered fully allocable to business activity.

Example 5. E, a managing executive and principal shareholder of X Company, travels from New York to Stockholm, Sweden, to attend a series of business meetings. At the conclusion of the series of meetings, which last 1 week, E spends 1 week on a personal vacation in Stockholm. If E establishes either that he did not have substantial control over the arranging of the trip or that a major consideration in determining to make the trip was not to provide an opportunity for taking a personal vacation, the entire travel expense to and from Stockholm shall be considered fully allocable to business activity.

Example 6. F, a self-employed professional man, flew from New York to Copenhagen, Denmark, to attend a convention sponsored by a professional society. The trip lasted 3 weeks, of which 2 weeks were spent on vacation in Europe. F generally would be regarded as having substantial control over arranging this business trip. Unless F can establish that obtaining a vacation was not a major consideration in determining to make the trip, the disallowance rules of this section apply.

Example 7. Taxpayer G flew from Chicago to New York where he spent 6 days on business. He then flew to London where he conducted business for 2 days. G then flew to Paris for a 5 day vacation after which he flew back to Chicago, with a scheduled landing in New York for the purpose of adding and discharging passengers. G would not have made the trip except for the business he had to conduct in London. The travel outside the United States away from home, including 2 days for travel en route, exceeded a week and the time devoted to nonbusiness activities was not less than 20 percent of the total time on such travel. The 2 days spent traveling from Chicago to New York and return, and the 6 days spent in New York are disregarded for purposes of determining whether the
§ 1.274–5 Substantiation requirements.

(a)–(b) [Reserved]. For further guidance, see §1.274–5T(a) and (b).

(c) Rules of substantiation—(1) [Reserved]. For further guidance, see §1.274–5T(c)(1).

(2) Substantiation by adequate records—(i) [Reserved]. For further guidance, see §1.274–5T(c)(2)(i).

(ii) [Reserved].

(iii) Documentary evidence—(A) Except as provided in paragraph (c)(2)(iii)(B), documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure, is required for—

(1) Any expenditure for lodging while traveling away from home, and

(2) Any other expenditure of $75 or more, except for transportation charges, documentary evidence will not be required if not readily available.

(B) The Commissioner, in his or her discretion, may prescribe rules waiving the documentary evidence requirements in circumstances where it is impracticable for such documentary evidence to be required. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, the date and amount of the expenditure, the number of people served, and, if a charge is made for an item other than meals and beverages, an indication that such is the case. A document may be indicative of only one (or part of one) element of an expenditure. Thus, a cancelled check, together with a bill from the payee, ordinarily would establish the element of cost. In contrast, a cancelled check drawn payable to a named payee would not by itself support a business expenditure without other evidence showing that the check was used for a certain business purpose.

(iv)–(v) [Reserved]. For further guidance, see §1.274–5T(c)(2)(iv) and (v).

(3)–(7) [Reserved]. For further guidance, see §1.274–5T(c)(3) through (7).

(d)–(e) [Reserved]. For further guidance, see §1.274–5T(d) and (e).

(f) Reporting and substantiation of expenses of certain employees for travel, entertainment, gifts, and with respect to listed property—(1) [Reserved]. For further guidance, see §1.274–5T(f)(1) through (3).

(4) Definition of an adequate accounting to the employer—(1) In general. For purposes of this paragraph (f) an adequate accounting means the submission to the employer of an account book, diary, log, statement of expense, trip sheet, or similar record maintained by the employee in which the information as to each element of an expenditure or use (described in paragraph (b) of this section) is recorded at or near the time of the expenditure or use, together with supporting documentary evidence, in a manner that conforms to all the adequate records requirements of paragraph (c)(2) of this section. An adequate accounting requires that the employee account for all amounts received from the employer during the taxable year as advances, reimbursements, or allowances (including those charged directly or indirectly to the

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employer through credit cards or otherwise) for travel, entertainment, gifts, and the use of listed property. The methods of substantiation allowed under paragraph (c)(4) or (c)(5) of this section also will be considered to be an adequate accounting if the employer accepts an employee's substantiation of and establishes that such substantiation meets the requirements of paragraph (c)(4) or (c)(5). For purposes of an adequate accounting, the method of substantiation allowed under paragraph (c)(3) of this section will not be permitted.

(ii) Procedures for adequate accounting without documentary evidence. The Commissioner may, in his or her discretion, prescribe rules under which an employee may make an adequate accounting to an employer by submitting an account book, log, diary, etc., alone, without submitting documentary evidence.

(iii) Employer. For purposes of this section, the term employer includes an agent of the employer or a third party payor who pays amounts to an employee under a reimbursement or other expense allowance arrangement.

(5) [Reserved]. For further guidance, see §1.274–5T(h).

(g) Substantiation by reimbursement arrangements or per diem, mileage, and other traveling allowances—(1) In general. The Commissioner may, in his or her discretion, prescribe rules in pronouncements of general applicability under which allowances for expenses described in paragraph (g)(2) of this section will, if in accordance with reasonable business practice, be regarded as equivalent to substantiation by adequate records or other sufficient evidence, for purposes of paragraph (c) of this section, of the amount of the expenses and as satisfying, with respect to the amount of the expenses, the requirements of an adequate accounting to the employer for purposes of paragraph (f)(4) of this section. If the total allowance received exceeds the deductible expenses paid or incurred by the employee, such excess must be reported as income on the employee's return.

See paragraph (j)(1) of this section relating to the substantiation of meal expenses while traveling away from home, and paragraph (j)(2) of this section relating to the substantiation of expenses for the business use of a vehicle.

(2) Allowances for expenses described. An allowance for expenses is described in this paragraph (g)(2) if it is a—

(i) Reimbursement arrangement covering ordinary and necessary expenses of traveling away from home (exclusive of transportation expenses to and from destination);

(ii) Per diem allowance providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination); or

(iii) Mileage allowance providing for ordinary and necessary expenses of local transportation and transportation to, from, and at the destination while traveling away from home.

(h) [Reserved]. For further guidance, see §1.274–5T(h).

(i) [Reserved]

(j) Authority for optional methods of computing certain expenses—(1) Meal expenses while traveling away from home. The Commissioner may establish a method under which a taxpayer may use a specified amount or amounts for meals while traveling away from home in lieu of substantiating the actual cost of meals. The taxpayer will not be relieved of the requirement to substantiate the actual cost of other travel expenses as well as the time, place, and business purpose of the travel. See paragraphs (b)(2) and (c) of this section.

(2) Use of mileage rates for vehicle expenses. The Commissioner may establish a method under which a taxpayer may use mileage rates to determine the amount of the ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home in lieu of substantiating the actual costs. The method may include appropriate limitations and conditions in order to reflect more accurately vehicle expenses over the entire period of usage. The taxpayer will not be relieved of the requirement to substantiate the amount of each business use (i.e., the business mileage), or the time and business purpose of each use. See paragraphs (b)(2) and (c) of this section.
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(3) Incidental expenses while traveling away from home. The Commissioner may establish a method under which a taxpayer may use a specified amount or amounts for incidental expenses paid or incurred while traveling away from home in lieu of substantiating the actual cost of incidental expenses. The taxpayer will not be relieved of the requirement to substantiate the actual cost of other travel expenses as well as the time, place, and business purpose of the travel.

(k) Exceptions for qualified nonpersonal use vehicles—(1) In general. The substantiation requirements of section 274(d) and this section do not apply to any qualified nonpersonal use vehicle (as defined in paragraph (k)(2) of this section).

(2) Qualified nonpersonal use vehicle—(i) In general. For purposes of section 274(d) and this section, the term qualified nonpersonal use vehicle means any vehicle which, by reason of its nature (that is, design), is not likely to be used more than a de minimis amount for personal purposes.

(ii) List of vehicles. Vehicles which are qualified nonpersonal use vehicles include the following:

(A) Clearly marked police, fire, and public safety officer vehicles (as defined and to the extent provided in paragraph (k)(3) of this section).

(B) Ambulances used as such or hearses used as such.

(C) Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds.

(D) Bucket trucks (cherry pickers).

(E) Cement mixers.

(F) Combiners.

(G) Cranes and derricks.

(H) Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat.

(I) Dump trucks (including garbage trucks).

(J) Flatbed trucks.

(K) Forklifts.

(L) Passenger buses used as such with a capacity of at least 20 passengers.

(M) Qualified moving vans (as defined in paragraph (k)(4) of this section).

(N) Qualified specialized utility repair trucks (as defined in paragraph (k)(5) of this section).

(O) Refrigerated trucks.

(P) School buses (as defined in section 4221(d)(7)(c)).

(Q) Tractors and other special purpose farm vehicles.

(R) Unmarked vehicles used by law enforcement officers (as defined in paragraph (k)(6) of this section) if the use is officially authorized.

(S) Such other vehicles as the Commissioner may designate.

(3) Clearly marked police, fire, or public safety officer vehicles. A police, fire, or public safety officer vehicle is a vehicle, owned or leased by a governmental unit, or any agency or instrumentality thereof, that is required to be used for commuting by a police officer, fire fighter, or public safety officer (as defined in section 402(l)(4)(C) of this chapter) who, when not on a regular shift, is on call at all times, provided that any personal use (other than commuting) of the vehicle outside the limit of the police officer’s arrest powers or the fire fighter’s or public safety officer’s obligation to respond to an emergency is prohibited by such governmental unit. A police, fire, or public safety officer vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police, fire, or public safety officer vehicle. A marking on a license plate is not a clear marking for purposes of this paragraph (k).

(4) Qualified moving van. The term qualified moving van means any truck or van used by a professional moving company in the trade or business of moving household or business goods if—

(i) No personal use of the van is allowed other than for travel to and from a move site (or for de minimis personal use, such as a stop for lunch on the way between two move sites);

(ii) Personal use for travel to and from a move site is an irregular practice (that is, not more than five times a month on average); and

(iii) Personal use is limited to situations in which it is more convenient to the employer, because of the location of the employee’s residence in relation to the location of the move site, for the van not to be returned to the employer’s business location.
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(5) Qualified specialized utility repair truck. The term qualified specialized utility repair truck means any truck (not including a van or pickup truck) specifically designed and used to carry heavy tools, testing equipment, or parts if—

(i) The shelves, racks, or other permanent interior construction which has been installed to carry and store such heavy items is such that it is unlikely that the truck will be used more than a de minimis amount for personal purposes; and

(ii) The employer requires the employee to drive the truck home in order to be able to respond in emergency situations for purposes of restoring or maintaining electricity, gas, telephone, water, sewer, or steam utility services.

(6) Unmarked law enforcement vehicles—(i) In general. The substantiation requirements of section 274(d) and this section do not apply to officially authorized uses of an unmarked vehicle by a “law enforcement officer”. To qualify for this exception, any personal use must be authorized by the Federal, State, county, or local governmental agency or department that owns or leases the vehicle and employs the officer, and must be incident to law-enforcement functions, such as being able to report directly from home to a stakeout or surveillance site, or to an emergency situation. Use of an unmarked vehicle for vacation or recreational purposes or for personal purposes outside the state. Thus, C’s use of the vehicle for commuting between headquarters and home and for personal errands outside the city limits. The police department generally has officially authorized personal use of the vehicle by C but has prohibited use of the vehicle for recreational purposes or for personal purposes outside the state. Therefore, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters and home and for personal errands outside the city limits.

(ii) Law enforcement officer. The term law enforcement officer means an individual who is employed on a full-time basis by a governmental unit that is responsible for the prevention or investigation of crime involving injury to persons or property (including apprehension or detention of persons for such crimes), who is authorized by law to carry firearms, execute search warrants, and to make arrests (other than merely a citizen’s arrest), and who regularly carries firearms (except when it is not possible to do so because of the requirements of undercover work). The term “law enforcement officer” may include an arson investigator if the investigator otherwise meets the requirements of this paragraph (k)(6)(ii), but does not include Internal Revenue Service special agents.

(7) Trucks and vans. The substantiation requirements of section 274(d) and this section apply generally to any pickup truck or van, unless the truck or van has been specially modified with the result that it is not likely to be used more than a de minimis amount for personal purposes. For example, a van that has only a front bench for seating, in which permanent shelving that fills most of the cargo area has been installed, that constantly carries merchandise or equipment, and that has been specially painted with advertising or the company’s name, is a vehicle not likely to be used more than a de minimis amount for personal purposes.

(8) Examples. The following examples illustrate the provisions of paragraph (k)(3) and (6) of this section:

Example 1. Detective C, who is a “law enforcement officer” employed by a state police department, headquartered in City M, is provided with an unmarked vehicle (equipped with radio communication) for use during off-duty hours because C must be able to communicate with headquarters and be available for duty at any time (for example, to report to a surveillance or crime site). The police department generally has officially authorized personal use of the vehicle by C but has prohibited use of the vehicle for recreational purposes or for personal purposes outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state. Thus, C’s use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands outside the state.

Example 2. Detective T is a “law enforcement officer” employed by City M. T is authorized to make arrests only within M’s city limits. T, along with all other officers of the force, is ordinarily on duty for eight hours each work day and on call during the other sixteen hours. T is provided with the use of a clearly marked police vehicle in which T is required to commute to his home in City M. The police department’s official policy regarding marked police vehicles prohibits its personal use (other than commuting) of the vehicles outside the city limits. When not using the vehicle on the job, T uses the vehicle only for commuting, personal errands on the way between work and home, and personal errands within City M.
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All use of the vehicle by T conforms to the requirements of paragraph (k)(3) of this section. Therefore, the value of that use is excluded from T’s gross income as a working condition fringe and the vehicle is not subject to the substantiation requirements of section 274(d).

Example 3. Director C is employed by City M as the director of the City’s rescue squad and is provided with a vehicle for use in responding to emergencies. Director C is trained in rescue activity and has the legal authority and legal responsibility to engage in rescue activity. The city’s rescue squad is not a part of City M’s police or fire department. The director’s vehicle is a sedan which is painted with insignia and words identifying the vehicle as being owned by the City’s rescue squad. When not on a regular shift, is on call at all times. The City’s official policy regarding clearly marked public safety officer vehicles prohibits personal use (other than for commuting) of the vehicle outside of the limits of the public safety officer’s obligation to respond to an emergency. When not using the vehicle to respond to emergencies, City M authorizes C to use the vehicle only for commuting, personal errands on the way between work and home, and personal errands within the limits of C’s obligation to respond to emergencies. With respect to these authorized uses, the vehicle is not subject to the substantiation requirements of section 274(d) and the value of these uses is not includable in C’s gross income.

Example 4. Coroner D is employed by County N to investigate and determine the cause, time, and manner of certain deaths occurring in the County. Coroner D also safeguards the property of the deceased, notifies the next of kin, conducts inquests, and arranges for the burial of indigent persons. D is provided with a vehicle for use by County N. The vehicle is to be used in County N business and for commuting. Personal use other than for commuting purposes is forbidden. D is trained in rescue activity but has no legal authority or legal responsibility to engage in rescue activity. D’s vehicle is a sedan which is painted with insignia and words identifying the vehicle as a County N vehicle. D, when not on a regular shift, is on call at all times. D does not satisfy the criteria of a public safety officer vehicle. Accordingly, D’s vehicle cannot qualify as a clearly marked public safety officer vehicle. Accordingly, use of the vehicle is subject to the substantiation requirements of section 274(d), and the value of any personal use of the vehicle, such as commuting, is includable in D’s gross income.

(1) Definitions. For purposes of section 274(d) and this section, the terms automobile and vehicle have the same meanings as prescribed in §1.61–21(d)(1)(i) and (e)(2), respectively. Also, for purposes of section 274(d) and this section, the terms employer, employee and personal use have the same meanings as prescribed in §1.274–6T(e).

(m) Effective date. This section applies to expenses paid or incurred after December 31, 1997. However, paragraph (j)(3) of this section applies to expenses paid or incurred after September 30, 2002, and paragraph (k) applies to clearly marked public safety officer vehicles, as defined in §1.274–5T(k)(3), only with respect to uses occurring after May 19, 2010.


§ 1.274–5T Substantiation requirements (temporary).

(a) In general. For taxable years beginning on or after January 1, 1986, no deduction or credit shall be allowed with respect to—

(1) Traveling away from home (including meals and lodging).

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e).

(3) Gifts defined in section 274(b), or

(4) Any listed property (as defined in section 280F(d)(4) and §1.280F–6T(b)), unless the taxpayer substantiates each element of the expenditure or use (as described in paragraph (b) of this section) in the manner provided in paragraph (c) of this section. This limitation supersedes the doctrine found in Cohan v. Commissioner, 28 F. 2d 540 (2d Cir. 1930). The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expenses but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction or credit shall be allowed a taxpayer on the basis of such approximations or unsupported testimony of
the taxpayer. For purposes of this section, the term *entertainment* means entertainment, amusement, or recreation, and use of a facility therefor; and the term *expenditure* includes expenses and items (including items such as losses and depreciation).

(b) Elements of an expenditure or use—

(1) In general. Section 274(d) and this section contemplate that no deduction or credit shall be allowed for travel, entertainment, a gift, or with respect to listed property unless the taxpayer substantiates the requisite elements of each expenditure or use as set forth in this paragraph (b).

(2) Travel away from home. The elements to be provided with respect to an expenditure for travel away from home are—

(i) Amount. Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler’s own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

(ii) Time. Dates of departure and return for each trip away from home, and number of days away from home spent on business;

(iii) Place. Destinations or locality of travel, described by name of city or town or other similar designation; and

(iv) Business purpose. Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel.

(3) Entertainment in general. The elements to be proved with respect to an expenditure for entertainment are—

(i) Amount. Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;

(ii) Time. Date of entertainment;

(iii) Place. Name, if any, address or location, and destination of type of entertainment, such as dinner or theater, if such information is not apparent from the designation of the place;

(iv) Business purpose. Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in section 274(e)(1), the nature of any business discussion or activity;

(v) Business relationship. Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(4) Entertainment directly preceding or following a substantial and bona fide business discussion. If a taxpayer claims a deduction for entertainment directly preceding or following a substantial and bona fide business discussion on the ground that such entertainment was associated with the active conduct of the taxpayer’s trade or business, the elements to be proved with respect to such expenditure, in addition to those enumerated in paragraph (b)(3) (i), (ii), (iii), and (v) of this section are—

(i) Time. Date and duration of business discussion;

(ii) Place. Place of business discussion;

(iii) Business purpose. Nature of business discussion, and business reason for the entertainment or nature of business benefit derived or expected to be derived as the result of the entertainment;

(iv) Business relationship. Identification of those persons entertained who participated in the business discussion.

(5) Gifts. The elements to be proved with respect to an expenditure for a gift are—

(i) Amount. Cost of the gift to the taxpayer;

(ii) Time. Date of the gift;

(iii) Description. Description of the gift;

(iv) Business purpose. Business reason for the gift or nature of business benefit derived or expected to be derived as a result of the gift; and

(v) Business relationship. Occupation or other information relating to the recipient of the gift, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(6) Listed property. The elements to be proved with respect to any listed property are—

(i) Amount—(A) Expenditures. The amount of each separate expenditure
with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures, and

(B) Uses. The amount of each business/investment use (as defined in §1.280F–6T (d)(3) and (e)), based on the appropriate measure (i.e., mileage for automobiles and other means of transportation and time for other listed property, unless the Commissioner approves an alternative method), and the total use of the listed property for the taxable period.

(ii) Time. Date of the expenditure or use with respect to listed property, and

(iii) Business or investment purpose. The business purpose for an expenditure or use with respect to any listed property (see §1.274–5T(c)(6)(i) (B) and (C) for special rules for the aggregation of expenditures and business use and §1.280F–6T(d)(2) for the distinction between qualified business use and business/investment use).

See also §1.274–5T(e) relating to the substantiation of business use of employer-provided listed property and §1.274–6T for special rules for substantiating the business/investment use of certain types of listed property.

(c) Rules of substantiation—(1) In general. Except as otherwise provided in this section and §1.274–6T, a taxpayer must substantiate each element of an expenditure or use (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute proof of each expenditure or use referred to in section 274. Written evidence has considerably more probative value than oral evidence alone. In addition, the probative value of written evidence is greater the closer in time it relates to the expenditure or use. A contemporaneous log is not required, but a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent there- to when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not make at or near the time of the expenditure or use must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with documentary evidence, as provided in paragraph (c)(2) of this section.

(2) Substantiation by adequate records—(i) In general. To meet the "adequate records" requirements of section 274(d), a taxpayer shall maintain an account book, diary, log, statement of expense, trip sheets, or similar record (as provided in paragraph (c)(2)(ii) of this section), and documentary evidence (as provided in paragraph (c)(2)(iii) of this section) which, in combination, are sufficient to establish each element of an expenditure or use specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, log, statement of expense, trip sheet, or similar record which duplicates information reflected on a receipt so long as the account book, etc. and receipt complement each other in an orderly manner.

(ii) Account book, diary, etc. An account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure or use is made at or near the time of the expenditure or use.

(A) Made at or near the time of the expenditure or use. For purposes of this section, the phrase made at or near the time of the expenditure or use means the element of an expenditure or use are recorded at a time when, in relation to the use or making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure or use, such as the amount, time, place, and business purpose of the expenditure and business relationship. An expense account statement which is a transcription of an account book,
diary, log, or similar record prepared or maintained in accordance with the provisions of this paragraph (c)(2)(ii) shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer or by an independent contractor to his client or customer in the regular course of good business practice. For example, a log maintained on a weekly basis, which accounts for use during the week, shall be considered a record made at or near the time of such use.

(B) Substantiation of business purpose. In order to constitute an adequate record of business purpose within the meaning of section 274(d) and this paragraph (c)(2), a written statement of business purpose generally is required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances of each case. Where the business purpose is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesman calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal described in section 274(e)(1), if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explanation of such business purpose will not be required.

(C) Substantiation of business use of listed property—(1) Degree of substantiation. In order to constitute an adequate record (within the meaning of section 274(d) and this paragraph (c)(2)(ii)), which substantiates business/investment use of listed property (as defined in §1.280F–6T(d)(3)), the record must contain sufficient information as to each element of every business/investment use. However, the level of detail required in an adequate record to substantiate business/investment use may vary depending upon the facts and circumstances. For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of a truck is to make deliveries to customers on an established route may satisfy the adequate record requirement by recording the total number miles driven during the taxable year, the length of the delivery route once, and the date of each trip at or near the time of the trips. Alternatively, the taxpayer may establish the date of each trip with a receipt, record of delivery, or other documentary evidence.

(2) Written record. Generally, an adequate record must be written. However, a record of the business use of listed property, such as a computer or automobile, prepared in a computer memory device with the aid of a logging program will constitute an adequate record.

(D) Confidential information. If any information relating to the elements of an expenditure or use, such as place, business purpose, or business relationship, is of a confidential nature, such information need not be set forth in the account book, diary, log, statement of expense, trip sheet, or similar record, provided such information is recorded at or near the time of the expenditure or use and is elsewhere available to the district director to substantiate such element of the expenditure or use.

(iii) [Reserved]. For further guidance, see §1.274–5(c)(2)(iii).

(iv) Retention of written evidence. The Commissioner may, in his discretion, prescribe rules under which an employer may dispose of the adequate records and documentary evidence submitted to him by employees who are required to, and do, make an adequate accounting to the employer (within the meaning of paragraph (f)(4) of this section) if the employer maintains adequate accounting procedures with respect to such employees (within the meaning of paragraph (f)(5) of this section).

(v) Substantial compliance. If a taxpayer has not fully substantiated a particular element of an expenditure or use, but the taxpayer establishes to the satisfaction of the district director that he has substantially complied with the “adequate records” requirements of this paragraph (c)(2) with respect to the expenditure or use, the
taxpayer may be permitted to establish such element by evidence which the district director shall deem adequate.

(3) Substantiation by other sufficient evidence—(i) In general. If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the “adequate records” requirements of paragraph (c)(2) of this section with respect to an element of an expenditure or use, then, except as otherwise provided in this paragraph, the taxpayer must establish such element—

(A) By his own statement, whether written or oral, containing specific information in detail as to such element; and

(B) By other corroborative evidence sufficient to establish such element.

If such element is the description of a gift, or the cost or amount, time, place, or date of an expenditure or use, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witnesses setting forth detailed information about such element, or the documentary evidence described in paragraph (c)(2) of this section. If such element is either the business relationship to the taxpayer of persons entertained, or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence.

(ii) Sampling—(A) In general. Except as provided in paragraph (c)(3)(i)(B) of this section, a taxpayer may maintain an adequate record for portions of a taxable year and use that record to substantiate the business/investment use of listed property or other vehicle of an employer that is made available for use by more than one employee for all or a portion of a taxable year.

(C) Examples. The following examples illustrate this paragraph (c)(3)(i).

Example 1. A, a sole proprietor and calendar year taxpayer, operates an interior decorating business out of her home. A uses an automobile for local business travel to visit the homes or offices of clients, to meet with suppliers and other subcontractors, and to pick up and deliver certain items to clients when feasible. There is no other business use of the automobile but A and other members of her family also use the automobile for personal purposes. A maintains adequate records for the first three months of 1986 that indicate that 75 percent of the use of the automobile was in A’s business. Invoices from subcontractors and paid bills indicate that A’s business continued at approximately the same rate for the remainder of 1986. If other circumstances do not change (e.g., A does not obtain a second car for exclusive use in her business), the determination that the business/investment use of the automobile for the taxable year is 75 percent is based on sufficient corroborative evidence.

Example 2. The facts are the same as in Example 1, except that A maintains adequate records during the first week of every month, which indicate that 75 percent of the use of the automobile is in A’s business. The invoices from A’s business indicate that A’s business continued at the same rate during the subsequent weeks of each month so that A’s weekly records are representative of each month’s business use of the automobile. Thus, the determination that the business/investment use of the automobile for the taxable year is 75 percent is based on sufficient corroborative evidence.

Example 3. B, a sole proprietor and calendar year taxpayer, is a salesman in a large metropolitan area for a company that manufactures household products. For the first three weeks of each month, B uses his own automobile occasionally to travel within the metropolitan area on business. During these three weeks, B’s use of the automobile for business purposes does not follow a consistent pattern from day to day or week to week. During the fourth week of each month, B delivers to his customers all the orders taken during the previous month. B’s use of his automobile for business purposes does not follow a consistent pattern from day to day or week to week. During the fourth week of each month, B delivers to his customers all the orders taken during the previous month. B’s use of his automobile for business purposes does not follow a consistent pattern from day to day or week to week.
(iii) Special rules. See §1.274-6T for special rules for substantiation by sufficient corroborating evidence with respect to certain listed property.

(4) Substantiation in exceptional circumstances. If a taxpayer establishes that, by reason of the inherent nature of the situation—

(i) He was unable to obtain evidence with respect to an element of the expenditure or use which conforms fully to the “adequate records” requirements of paragraph (c)(2) of this section,

(ii) He is unable to obtain evidence with respect to such element which conforms fully to the “other sufficient evidence” requirements of paragraph (c)(3) of this section, and

(iii) He has presented other evidence, with respect to such element, which possesses the highest degree of probative value possible under the circumstances, such other evidence shall be considered to satisfy the substantiation requirements of section 274(d) and this paragraph.

(5) Loss of records due to circumstances beyond control of the taxpayer. Where the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer’s control, such as destruction by fire, flood, earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures or use.

(6) Special rules—(1) Separate expenditure or use—(A) In general. For the purposes of this section, each separate payment or use by the taxpayer shall ordinarily be considered to constitute a separate expenditure. However, concurrent or repetitious expenses or uses may be substantiated as a single item. To illustrate the above rules, where a taxpayer entertains a business guest at dinner and thereafter at the theater, the payment for dinner shall be considered to constitute one expenditure and the payment for the tickets for the theater shall be considered to constitute a separate expenditure. Similarly, if during a day of business travel a taxpayer makes separate payments for breakfast, lunch, and dinner, he shall be considered to have made three separate expenditures. However, if during entertainment at a cocktail lounge the taxpayer pays separately for each serving of refreshments, the total amount expended for the refreshments will be treated as a single expenditure. A tip may be treated as a separate expenditure.

(B) Aggregation of expenditures. Except as otherwise provided in this section, the account book, diary, log, statement of expense, trip sheet, or similar record required by paragraph (c)(2)(i) of this section shall be maintained with respect to each separate expenditure and not with respect to aggregate amounts for two or more expenditures. Thus, each expenditure for such items as lodging and air or rail travel shall be recorded as a separate item and not aggregated. However, at the option of the taxpayer, amounts expended for breakfast, lunch, or dinner, may be aggregated. A tip or gratuity which is related to an underlying expense may be aggregated with such expense. In addition, amounts expended in connection with the use of listed property during a taxable year, such as for gasoline or repairs for an automobile, may be aggregated. If these expenses are aggregated, the taxpayer must establish the date and amount, but need not prove the business purpose of each expenditure. Instead, the taxpayer may prorate the expenses based on the total business use of the listed property. For other provisions permitting recording of aggregate amounts in an account book, diary, log, statement of expense, trip sheet, or similar record, see paragraphs (b)(2)(i) and (b)(3) of this section (relating to incidental costs of travel and entertainment).

(C) Aggregation of business use. Uses which may be considered part of a single use, for example, a round trip or uninterrupted business use, may be accounted for by a single record. For example, use of a truck to make deliveries at several different locations which begins and ends at the business premises and which may include a stop at the business premises in between two deliveries may be accounted for by a single record of miles driven. In addition, use of a passenger automobile by a salesman for a business trip away from home over a period of time may
be accounted for by a single record of miles traveled. De minimis personal use (such as a stop for lunch on the way between two business stops) is not an interruption of business use.

(ii) **Allocation of expenditure.** For purposes of this section, if a taxpayer has established the amount of an expenditure, but is unable to establish the portion of such amount which is attributable to each person participating in the event giving rise to the expenditure, such amount shall ordinarily be allocated to each participant on a pro rata basis, if such determination is material. Accordingly, the total number of persons for whom a travel or entertainment expenditure is incurred must be established in order to compute the portion of the expenditure allocable to such person.

(iii) **Primary use of a facility.** Section 274(a) (1)(B) and (2)(C) deny a deduction for any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred before January 1, 1994, with respect to a club, used in connection with an entertainment activity unless the taxpayer establishes that the facility (including a club) was used primarily for the furtherance of the taxpayer’s trade or business. A determination whether a facility before January 1, 1979, or a club before January 1, 1994, was used in connection with an entertainment activity unless the taxpayer establishes that the facility (including a club) was used primarily for the furtherance of his trade or business, the taxpayer shall maintain records of the use of the facility, the cost of using the facility, mileage or its equivalent (if appropriate), and such other information as shall tend to establish such primary use. Such records of use shall contain—

(A) For each use of the facility claimed to be in furtherance of the taxpayer’s trade or business, the elements of an expenditure specified in paragraph (b)(3) of this section, and

(B) For each use of the facility not in furtherance of the taxpayer’s trade or business, an appropriate description of such use, including cost, date, number of persons entertained, nature of entertainment and, if applicable, information such as mileage or its equivalent. A notation such as “personal use” or “family use” would, in the case of such use, be sufficient to describe the nature of entertainment.

If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such facility was primarily personal.

(iv) **Additional information.** In a case where it is necessary to obtain additional information, either—

(A) To clarify information contained in records, statements, testimony, or documentary evidence submitted by a taxpayer under the provisions of paragraph (c)(2) or (c)(3) of this section, or

(B) To establish the reliability or accuracy of such records, statements, testimony, or documentary evidence, the district director may, notwithstanding any other provision of this section, obtain such additional information by personal interview or otherwise as he determines necessary to implement properly the provisions of section 274 and the regulations thereunder.

(7) **Specific exceptions.** Except as otherwise prescribed by the Commissioner, substantiation otherwise required by this paragraph is not required for—

(i) Expenses described in section 274(e)(2) relating to food and beverages for employees, section 274(e)(3) relating to expenses treated as compensation, section 274(e)(8) relating to items available to the public, and section 274(e)(9) relating to entertainment sold to customers, and

(ii) Expenses described in section 274(e)(5) relating to recreational, etc., expenses for employees, except that a taxpayer shall keep such records or other evidence as shall establish that such expenses were for activities (or facilities used in connection therewith) primarily for the benefit of employees other than employees who are officers, shareholders or other owners (as defined in section 274(e)(5)), or highly compensated employees.

(d) **Disclosure on returns**—(1) In general. The Commissioner may, in his discretion, prescribe rules under which any taxpayer claiming a deduction or credit for entertainment, gifts, travel,
or with respect to listed property, or any other person receiving advances, reimbursements, or allowances for such items, shall make disclosure on his tax return with respect to such items. The provisions of this paragraph shall apply notwithstanding the provisions of paragraph (f) of this section.

(2) Business use of passenger automobiles and other vehicles. (i) On returns for taxable years beginning after December 31, 1984, taxpayers that claim a deduction or credit with respect to any vehicle are required to answer certain questions providing information about the use of the vehicle. The information required on the tax return relates to mileage (total, business, commuting, and other personal mileage), percentage of business use, date placed in service, use of other vehicles, after-work use, whether the taxpayer has evidence to support the business use claimed on the return, and whether or not the evidence is written.

(ii) Any employer that provides the use of a vehicle to an employee must obtain information from the employee sufficient to complete the employer’s tax return. Any employer that provides more than five vehicles to its employees need not include any information on its return. The employer, instead, must obtain the information from its employees, indicate on its return that it has obtained the information, and retain the information received. Any employer—

(A) That can satisfy the requirements of §1.274–6T(a)(2), relating to vehicles not used for personal purposes,

(B) That can satisfy the requirements of §1.274–6T(a)(3), relating to vehicles not used for personal purposes other than commuting, or

(C) That treats all use of vehicles by employees as personal use need not obtain information with respect to those vehicles, but instead must indicate on its return that it has vehicles exempt from the requirements of this paragraph (d)(2).

(3) Business use of other listed property. On returns for taxable years beginning after December 31, 1984, taxpayers that claim a deduction or credit with respect to any listed property other than a vehicle (for example, a yacht, airplane, or certain computers) are required to provide the following information:

(i) The date that the property was placed in service,

(ii) The percentage of business use,

(iii) Whether evidence is available to support the percentage of business use claimed on the return, and

(iv) Whether the evidence is written.

(e) Substantiation of the business use of listed property made available by an employer for use by an employee—(1) Employee—(i) In general. An employee may not exclude from gross income as a working condition fringe any amount of the value of the availability of listed property provided by an employer to the employee, unless the employee substantiates for the period of availability the amount of the exclusion in accordance with the requirements of section 274(d) and either this section or §1.274–6T.

(ii) Vehicles treated as used entirely for personal purposes. If an employer includes the value of the availability of a vehicle (as defined in §1.61–21(e)(2)) in an employee’s gross income without taking into account any exclusion for a working condition fringe allowable under section 132 and the regulations thereunder with respect to the vehicle, the employee must substantiate any deduction claimed under §§1.162–25 and 1.162–25T for the business/investment use of the vehicle in accordance with the requirements of section 274(d) and either this section or §1.274–6T.

(2) Employer—(i) In general. An employer substantiates its business/investment use of listed property by showing either—

(A) That, based on evidence that satisfies the requirements of section 274(d) or statements submitted by employees that summarize such evidence, all or a portion of the use of the listed property is by employees in the employer’s trade or business and, if any employee used the property for personal purposes, the employer included an appropriate amount in the employee’s income, or

(B) In the case of a vehicle, the employer treats all use by employees as personal use and includes an appropriate amount in the employees’ income.
(ii) Reliance on employee records. For purposes of substantiating the business/investment use of listed property that an employer provides to an employee and for purposes of the information required by paragraph (d)(2) and (3) of this section, the employer may rely on adequate records maintained by the employee or on the employee’s own statement if corroborated by other sufficient evidence unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate. The employer must retain a copy of the adequate records maintained by the employee or the other sufficient evidence, if available. Alternatively, the employer may rely on a statement submitted by the employee that provides sufficient information to allow the employer to determine the business/investment use of the property unless the employer knows or has reason to know that the statement is not based on adequate records or on the employee’s own statement corroborated by other sufficient evidence. If the employer relies on the employee’s statement, the employer must retain only a copy of the statement. The employee must retain a copy of the adequate records or other evidence.

(f) Reporting and substantiation of expenses of certain employees for travel, entertainment, gifts, and with respect to listed property—(1) In general. The purpose of this paragraph is to provide rules for reporting and substantiation of certain expenses paid or incurred by employees in connection with the performance of services as employees. For purposes of this paragraph, the term business expenses means ordinary and necessary expenses for travel, entertainment, gifts, or with respect to listed property which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by section 262, 274(c), and 280F. Thus, the term business expenses does not include personal, living, or family expenses disallowed by section 262, travel expenses disallowed by section 274(c), or cost recovery deductions and credits with respect to listed property disallowed by section 280F(d)(3) because the use of such property is not for the convenience of the employer and required as a condition of employment. Except as provided in paragraph (f)(2), advances, reimbursements, or allowances for such expenditures must be reported as income by the employee.

(2) Reporting of expenses for which the employee is required to make an adequate accounting to his employer—(i) Reimbursements equal to expenses. For purposes of computing tax liability, an employee need not report on his tax return business expenses for travel, transportation, entertainment, gifts, or with respect to listed property, paid or incurred by him solely for the benefit of his employer for which he is required to, and does, make an adequate accounting to his employer (as defined in paragraph (f)(4) of this section) which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided that the total amount of such advances, reimbursements, and charges is equal to such expenses.

(ii) Reimbursements in excess of expenses. In case the total of the amounts charged directly or indirectly to the employer or received from the employer as advances, reimbursements, or otherwise, exceeds the business expenses paid or incurred by the employee and the employee is required to, and does, make an adequate accounting to his employer for such expenses, the employee must include such excess (including amounts received for expenditures not deductible by him) in income.

(iii) Expenses in excess of reimbursements. If an employee incurs deductible business expenses on behalf of his employer which exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee makes an adequate accounting to his employer, the employee must be able to substantiate any deduction for such excess with such records and supporting evidence as will substantiate each element of an expenditure (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.
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(3) Reporting of expenses for which the employee is not required to make an adequate accounting to his employer. If the employee is not required to make an adequate accounting to his employer for his business expenses or, though required, fails to make an adequate accounting for such expenses, he must submit, as a part of his tax return, the appropriate form issued by the Internal Revenue Service for claiming deductions for employee business expenses (e.g., Form 2106, Employee Business Expenses, for 1985) and provide the information requested on that form, including the information required by paragraph (d)(2) and (3) of this section if the employee’s business expenses are with respect to the use of listed property. In addition, the employee must maintain such records and supporting evidence as will substantiate each element of an expenditure or use (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(4) [Reserved]. For further guidance, see §1.274–5(f)(4).

(5) Substantiation of expenditures by certain employees. An employee who makes an adequate accounting to his employer within the meaning of this paragraph will not again be required to substantiate such expense account information except in the following cases:

(i) An employee whose business expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise who claims a deduction on his return for such excess,

(ii) An employee who is related to his employer within the meaning of section 267(b) but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent, and

(iii) Employees in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by such employees are not adequate, or where it cannot be determined that such procedures are adequate. The district director will determine whether the employer's accounting procedures are adequate by considering the facts and circumstances of each case, including the use of proper internal controls.

For example, an employer should require that an expense account be verified and approved by a reasonable person other than the person incurring such expenses. Accounting procedures will be considered inadequate to the extent that the employer does not require an adequate accounting from his employees as defined in paragraph (f)(4) of this section, or does not maintain such substantiation. To the extent an employer fails to maintain adequate accounting procedures he will thereby obligate his employees to substantiate separately their expense account information.

(g) [Reserved]. For further guidance, see §1.274–5(g).

(h) Reporting and substantiation of certain reimbursements of persons other than employees—(1) In general. The purpose of this paragraph is to provide rules for the reporting and substantiation of certain expenses for travel, entertainment, gifts, or with respect to listed property paid or incurred by one person (hereinafter termed “independent contractor”) in connection with services performed for another person other than an employer (hereinafter termed “client or customer”) under a reimbursement or other expense allowance arrangement with such client or customer. For purposes of this paragraph, the term business expenses means ordinary and necessary expenses for travel, entertainment, gifts, or with respect to listed property which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by sections 262 and 274(c). Thus, the term business expenses does not include personal, living, or family expenses disallowed by section 262 or travel expenses disallowed by sections 262 or 274(c), and reimbursements for such expenditures must be reported as income by the independent contractor. For purposes of this paragraph, the term reimbursements means advances, allowances, or reimbursements received by an independent contractor for travel, entertainment, gifts, or with respect to listed property in connection with the performance by him of services for his client or customer, under a reimbursement or other expense allowance arrangement with his client or customer, and includes amounts charged directly.
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The provisions of §§1.274–1 through 1.274–5, inclusive, do not apply to any deduction allowable to the taxpayer without regard to its connection with the taxpayer’s trade or business or other income producing activity. Examples of such items are interest, taxes such as real property taxes, and casualty losses. Thus, if a taxpayer owned a fishing camp, the taxpayer could still deduct mortgage interest or indirectly to the client or customer through credit card systems or otherwise. See paragraph (j) of this section relating to the substantiation of meal expenses while traveling away from home.

(2) Substantiation by independent contractors. An independent contractor shall substantiate, with respect to his reimbursements, each element of an expenditure (described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section; and, to the extent he does not so substantiate, he shall include such reimbursements in income. An independent contractor shall so substantiate a reimbursement for entertainment regardless of whether he accounts (within the meaning of paragraph (h)(3) of this section) for such entertainment.

(3) Accounting to a client or customer under section 274(e)(4)(B). Section 274(e)(4)(B) provides that section 274(a) (relating to disallowance of expenses for entertainment) shall not apply to expenditures for entertainment for which an independent contractor has been reimbursed if the independent contractor accounts to his client or customer, to the extent provided by section 274(d). For purposes of section 274(e)(4)(B), an independent contractor shall be considered to account to his client or customer for an expense paid or incurred under a reimbursement or other expense allowance arrangement with his client or customer if, with respect to such expense for entertainment, he submits to his client or customer adequate records or other sufficient evidence conforming to the requirements of paragraph (c) of this section.

(4) Substantiation by client or customer. A client or customer shall not be required to substantiate, in accordance with the requirements of paragraph (c) of this section, reimbursements to an independent contractor for travel and gifts, or for entertainment unless the independent contractor has accounted to him (within the meaning of section 274(e)(4)(B) and paragraph (h)(3) of this section) for such entertainment. If an independent contractor has so accounted to a client or customer for entertainment, the client or customer shall substantiate each element of the expenditure (as described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section.

(i) [Reserved]

(j) [Reserved]. For further guidance, see §1.274–5(j).

(k) and (l) [Reserved] For further guidance, see §1.274–5(k) and (l).

(m) Effective date. Section 274(d), as amended by the Tax Reform Act of 1984 and Public Law 99–44, and this section (except as provided in paragraph (d)(2) and (3) of this section) apply with respect to taxable years beginning after December 31, 1985. Section 274(d) and this section apply to any deduction or credit claimed in a taxable year beginning after December 31, 1993, with respect to any listed property, regardless of the taxable year in which the property was placed in service. However, except as provided in §1.132–5(h) with respect to qualified nonpersonal use vehicles, the substantiation requirements of section 274(d) and this section do not apply to the determination of an employee’s working condition fringe exclusion or to the determination under §1.162–25(b) of an employee’s deduction before the date that those requirements apply, under this paragraph (m), to the employer, if the employer is taxable. Paragraph (j)(3) of this section applies to expenses paid or incurred after September 30, 2002.


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and real property taxes in full even if deductions for its use are not allowable under section 274(a) and §1.274-2. In the case of a taxpayer which is not an individual, the provisions of this section shall be applied as if it were an individual. Thus, if a corporation sustains a casualty loss on an entertainment facility used in its trade or business, it could deduct the loss even though deductions for the use of the facility are not allowable.

[T.D. 8051, 50 FR 36576, Sept. 9, 1985]

§ 1.274–6T Substantiation with respect to certain types of listed property for taxable years beginning after 1985 (temporary).

(a) Written policy statements as to vehicles—(1) In general. Two types of written policy statements satisfying the conditions described in paragraph (a)(2) and (3) of this section, if initiated and kept by an employer to implement a policy of no personal use, or no personal use except for commuting, of a vehicle provided by the employer, qualify as sufficient evidence corroborating the taxpayer’s own statement and therefore will satisfy the employer’s substantiation requirements under section 274(d). Therefore, the employee need not keep a separate set of records for purposes of the employer’s substantiation requirements under section 274(d) with respect to use of a vehicle satisfying these written policy statement rules. A written policy statement adopted by a governmental unit as to employee use of its vehicles qualifies for these exceptions to the section 274(d) substantiation rules. Thus, a resolution of a city council or a provision of state law or a state constitution would qualify as a written policy statement, as long as the conditions described in paragraph (a)(2) and (3) of this section are met.

(2) Vehicles not used for personal purposes—(i) Employers. A policy statement that prohibits personal use by an employee satisfies an employer’s substantiation requirements under section 274(d) if all the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer’s trade or business,

(B) When the vehicle is not used in the employer’s trade or business, it is kept on the employer’s business premises, unless it is temporarily located elsewhere, for example, for maintenance or because of a mechanical failure,

(C) No employee using the vehicle lives at the employer’s business premises,

(D) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, except for de minimis personal use (such as a stop for lunch between two business deliveries), and

(E) The employer reasonably believes that, except for de minimis use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose.

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle meets the preceding five conditions.

(ii) Employees. An employee, in lieu of substantiating the business/investment use of an employer-provided vehicle under §1.274–5T, may treat all use of the vehicle as business/investment use if the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer’s trade or business,

(B) When the vehicle is not used in the employer’s trade or business, it is kept on the employer’s business premises, unless it is temporarily located elsewhere, for example, for maintenance or because of a mechanical failure,

(C) No employee using the vehicle lives at the employer’s business premises,

(D) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, except for de minimis personal use (such as a stop for lunch between two business deliveries), and

(E) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to
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the employee, uses the vehicle for any personal purpose.

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle meets the preceding five conditions.

(3) Vehicles not used for personal purposes other than commuting—(i) Employers. A policy statement that prohibits personal use by an employee, other than commuting, satisfies an employer’s substantiation requirements under section 274(d) if all the following conditions are met:

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer’s trade or business and is used in the employer’s trade or business,

(B) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle,

(C) The employer has established a written policy under which neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee’s home),

(D) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting,

(E) The employee required to use the vehicle for commuting is not a control employee (as defined in §1.61–2T(f) (5) and (6)) required to use an automobile (as defined in §1.61–2T(d)(1)(ii)), and

(F) The employer accounts for the commuting use by including in the employee’s gross income the commuting value determined by the employer as provided in §1.61–2T(f)(3) (to the extent not reimbursed by the employee).

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

(ii) Employees. An employee, in lieu of substantiating the business/investment use of an employer-provided vehicle under §1.274–5T, may substantiate any exclusion allowed under section 132 for a working condition fringe by including in income the commuting value of the vehicle (determined by the employer pursuant to §1.61–2T(f)(3)) if all the following conditions are met:

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer’s trade or business and is used in the employer’s trade or business,

(B) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle,

(C) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee’s home),

(D) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting,

(E) The employee required to use the vehicle for commuting is not a control employee (as defined in §1.61–2T(f) (5) and (6)) required to use an automobile (as defined in §1.61–2T(d)(1)(ii)), and

(F) The employee includes in gross income the commuting value determined by the employer as provided in §1.61–2T(f)(3) (to the extent that the employee does not reimburse the employer for the commuting use).

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

(b) Vehicles used in connection with the business of farming—(1) In general. If, during a taxable year or shorter period, a vehicle, not otherwise described in section 274(i), §1.274–5T(c), or paragraph (a) (2) or (3) of this section, is owned or leased by an employer and used during most of a normal business day directly in connection with the business of farming (as defined in paragraph (b)(2) of this section), the employer, in lieu of substantiating the use
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of the vehicle as prescribed in §1.274–5T(b)(6)(i)(B), may determine any deduction or credit with respect to the vehicle as if the business/investment use (as defined in §1.280F–6T(d)(3)(i)) and the qualified business use (as defined in §1.280F–6T(d)(2)) of the vehicle in the business of farming for the tax-able year or shorter period were 75 percent plus that percentage, if any, attributable to an amount included in an employee’s gross income. If the vehicle is also available for personal use by employees, the employer must include the value of that personal use in the gross income of the employees, allocated among them in the manner prescribed in §1.132–5T(g).

(2) Directly in connection with the business of farming. The phrase directly in connection with the business of farming means that the vehicle must be used directly in connection with the business of operating a farm (i.e., cultivating land or raising or harvesting any agricultural or horticultural commodity, or the raising, shearing, feeding, caring for, training, and management of animals) or incidental thereto (for example, trips to the feed and supply store).

(3) Substantiation by employees. If an employee is provided with the use of a vehicle to which this paragraph (b) applies, the employee may, in lieu of substantiating the business/investment use of the vehicle in the manner prescribed in §1.274–5T, substantiate any exclusion allowed under section 132 for a working condition fringe as if the business/investment use of the vehicle were 75 percent, plus that percentage, if any, determined by the employer to be attributable to the use of the vehicle by individuals other than the employee, provided that the employee includes in gross income the amount determined by the employer as includible in the employee’s gross income. See §1.132–5T(g)(3) for examples illustrating the allocation of use of a vehicle among employees.

(c) Vehicles treated as used entirely for personal purposes. An employer may satisfy the substantiation requirements under section 274(d) for a taxable year or shorter period with respect to the business use of a vehicle that is provided to an employee by including the value of the availability of the vehicle during the relevant period in the employee’s gross income without any exclusion for a working condition fringe with respect to the vehicle and, if required, by withholding any taxes. Under these circumstances, the employer’s business/investment use of the vehicle during the relevant period is 100 percent. The employer’s qualified business use of the vehicle is dependent upon the relationship of the employee to the employer (see §1.280F–6T(d)(2)).

(d) Limitations. If a taxpayer chooses to satisfy the substantiation requirements of sections 274(d) and §1.274–5T by using one of the methods prescribed in paragraphs (a) (2) or (3), (b), or (c) of this section and files a return with the Internal Revenue Service for a taxable year consistent with such choice, the taxpayer may not later use another of these methods. Similarly, if a taxpayer chooses to satisfy the substantiation requirements of section 274(d) in the manner prescribed in §1.274–5T and files a return with the Internal Revenue Service for a taxable year consistent with such choice, the taxpayer may not later use a method prescribed in paragraph (a) (2) or (3), (b), or (c) of this section. This rule applies to an employee for purposes of substantiating any working condition fringe exclusion as well as to an employer. For example, if an employee excludes on his federal income tax return for a taxable year 90 percent of the value of the availability of an employer-provided automobile on the basis of records that allegedly satisfy the “adequate records” requirement of §1.274–5T(c)(2), and that requirement is not satisfied, the employee may then not satisfy the substantiation requirements of section 274(d) for the taxable year by any method prescribed in this section, but may present other corroborative evidence as prescribed in §1.274–5T(c)(3).

(e) Definitions—(1) In general. The definitions provided in this paragraph (e) apply for purposes of section 274(d), §1.274–5T, and this section.

(2) Employer and employee. The terms employer and employee include the following:

(i) A sole proprietor shall be treated as both an employer and employee,
(i) A partnership shall be treated as an employer of its partners, and
(ii) A partner shall be treated as an employee of the partnership.

(3) Automobie. The term automobile has the same meaning as prescribed in §1.61–2T(d)(1)(i).

(4) Vehicle. The term vehicle has the same meaning as prescribed in §1.61–2T(e)(2).

(5) Personal use. Personal use by an employee of an employer-provided vehicle includes use in any trade or business other than the trade or business of being the employee of the employer providing the vehicle.

(f) Effective date. This section is effective for taxable years beginning after December 31, 1985.


§ 1.274–7 Treatment of certain expenditures with respect to entertainment-type facilities.

If deductions are disallowed under §1.274–2 with respect to any portion of a facility, such portion shall be treated as an asset which is used for personal, living, and family purposes (and not as an asset used in a trade or business). Thus, the basis of such a facility will be adjusted for purposes of computing depreciation deductions and determining gain or loss on the sale of such facility in the same manner as other property (for example, a residence) which is regarded as used partly for business and partly for personal purposes.

[T.D. 6659, 28 FR 6507, June 25, 1963]

§ 1.274–8 Effective date.

Except as provided in §1.274–2 and (e), §§1.274–1 through 1.274–7 apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

[T.D. 8061, 50 FR 36576, Sept. 9, 1985]

§ 1.275–1 Deduction denied in case of certain taxes.

For description of the taxes for which a deduction is denied under section 275, see paragraphs (a), (b), (c), (e), and (h) of §1.164–2.


§ 1.276–1 Disallowance of deductions for certain indirect contributions to political parties.

(a) In general. Notwithstanding any other provision of law, no deduction shall be allowed for income tax purposes in respect of any amount paid or incurred after March 15, 1966, in a taxable year of the taxpayer beginning after December 31, 1965, for any expenditure to which paragraph (b)(1), (c), (d), or (e) of this section is applicable. Section 276 is a disallowance provision exclusively and does not make deductible any expenses which are not otherwise allowed under the Code. For certain other rules in respect of deductions for expenditures for political purposes, see §§1.162–15(b), 1.162–20, and 1.271–1.

(b) Advertising in convention program—
(1) General rule. (i) Except as provided in subparagraph (2) of this paragraph, no deduction shall be allowed for an expenditure for advertising in a convention program of a political party. For purposes of this subparagraph it is immaterial who publishes the convention program or to whose use the proceeds of the program inure (or are intended to inure). A convention program is any written publication (as defined in paragraph (c) of this section) which is distributed or displayed in connection with or at a political convention, conclave, or meeting. Under certain conditions payments to a committee organized for the purpose of bringing a political convention to an area are deductible under paragraph (b) of §1.162–15. This rule is not affected by the provisions of this section. For example, such payments may be deductible notwithstanding the fact that the committee purchases from a political party the right to publish a pamphlet in connection with a convention and that the deduction of costs of advertising in the pamphlet is prohibited under this section.

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

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Example. M Corporation publishes the convention program of the Y political party for a convention not described in subparagraph (2) of this paragraph. The corporation makes no payment of any kind to or on behalf of the party or any of its candidates and no part of the proceeds of the publication and sale of the program inures directly or indirectly to the benefit of any political party or candidate. P Corporation purchases an advertisement in the program. P Corporation may not deduct the cost of such advertisement.

(2) Amounts paid or incurred on or after January 1, 1968, for advertising in programs of certain national political conventions.

(i) Subject to the limitations in subdivision (ii) of this subparagraph, a deduction may be allowed for any amount paid or incurred on or after January 1, 1968, for advertising in a convention program of a political party distributed in connection with a convention held for the purpose of nominating candidates for the offices of President and Vice President of the United States, if the proceeds from the program are actually used solely to defray the costs of conducting the convention (or are set aside for such use at the next convention of the party held for such purpose) and if the amount paid or incurred for the advertising is reasonable. If such amount is not reasonable or if any part of the proceeds is used for a purpose other than that of defraying such convention costs, no part of the amount is deductible. Whether or not an amount is reasonable shall be determined in light of the business the taxpayer may expect to receive either directly as a result of the advertising or as a result of the convention being held in an area in which the taxpayer has a principal place of business. For these purposes, an amount paid or incurred for advertising will not be considered as reasonable if it is greater than the amount which would be paid for comparable advertising in a comparable convention program of a nonpolitical organization. Institutional advertising (e.g., advertising of a type not designed to sell specific goods or services to persons attending the convention) is not advertising which may be expected to result directly in business for the taxpayer sufficient to make the expenditures reasonable. Accordingly, an amount spent for institutional advertising in a convention program may be deductible only if the taxpayer has a principal place of business in the area where the convention is held. An official statement made by a political party after a convention as to the use made of the proceeds from its convention program shall constitute prima facie evidence of such use.

(ii) No deduction may be taken for any amount described in this subparagraph which is not otherwise allowable as a deduction under section 162, relating to trade or business expenses. Therefore, in order for any such amount to be deductible, it must first satisfy the requirements of section 162, and, in addition, it must also satisfy the more restrictive requirements of this subparagraph.

(c) Advertising in publication other than convention program. No deduction shall be allowed for an expenditure for advertising in any publication other than a convention program if any part of the proceeds of such publication directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate. For purposes of this paragraph, a publication includes a book, magazine, pamphlet, brochure, flier, almanac, newspaper, newsletter, handbill, billboard, menu, sign, scorecard, program, announcement, radio or television program or announcement, or any similar means of communication. For the definition of inurement of proceeds to a political party or a political candidate, see paragraph (f)(3) of this section.

(d) Admission to dinner or program. No deduction shall be allowed for an expenditure for admission to any dinner or program, if any part of the proceeds of such event directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate. For purposes of this paragraph, a dinner or program includes a gala, dance, ball, theatrical or film presentation, cocktail or other party, picnic, barbecue, sporting event, brunch, tea, supper, auction, bazaar, reading, speech, forum, lecture, fashion show, concert, opening, meeting, gathering, or any similar event. For the definition of inurement of proceeds to
(e) Admission to inaugural event. (1) No deduction shall be allowed for an expenditure for admission to an inaugural ball, inaugural gala, inaugural parade, or inaugural concert, or to any similar event (such as a dinner or program, as defined in paragraph (d) of this section), in connection with the inauguration or installation in office of any official, or any equivalent event for an unsuccessful candidate, if the event is identified with a political party or a political candidate. For purposes of this paragraph, the sponsorship of the event and the use to which the proceeds of the event are or may be put are irrelevant, except insofar as they may tend to identify the event with a political party or a political candidate. For the definition of admission to an inaugural event, see paragraph (f)(4) of this section.

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

Example. An inaugural reception for A, a prominent member of Y party who has been recently elected judge of the municipal court of F city, is held with the proceeds going to the city treasury. The price of admission to such affair is not deductible.

(f) Definitions—(1) Political party. For purposes of this section the term political party has the same meaning as that provided for in paragraph (b)(1) of §1.271–1.

(2) Political candidate. For purposes of this section, the term political candidate is to be construed in accordance with the purpose of section 276 to deny tax deductions for certain expenditures which may be used directly or indirectly to finance political campaigns. The term includes a person who, at the time of the event or publication with respect to which the deduction is being sought, has been selected or nominated by a political party for any elective office. It also includes an individual who is generally believed, under the facts and circumstances at the time of the event or publication, by the persons making expenditures in connection therewith to be an individual who is or who in the reasonably foreseeable future will be seeking selection, nomination, or election to any public office. For purposes of the preceding sentence, the facts and circumstances to be considered include, but are not limited to, the purpose of the event or publication and the disposition to be made of the proceeds. In the absence of evidence to the contrary it shall be presumed that persons making expenditures in connection with an event or publication generally believe that an incumbent of an elective public office will run for reelection to his office or for election to some other public office.

(3) Inurement of proceeds to political party or political candidate—(i) In general. Subject to the special rules presented in subdivision (iii) of this subparagraph (relating to a political candidate), proceeds directly or indirectly inure to or for the use of a political party or a political candidate (a) if the party or candidate may order the disposition of any part of such proceeds, regardless of what use is actually made thereof, or (b) if any part of such proceeds is utilized by any person for the benefit of the party or candidate. These conditions are equally applicable in determining whether the proceeds are intended to inure. Accordingly, it is immaterial whether the event or publication operates at a loss if, had there been a profit, any part of the proceeds would have inured to or for the use of a political party or a political candidate. Moreover, it shall be presumed that where a dinner, program, or publication is sponsored by or identified with a political party or political candidate, the proceeds of such dinner, program, or publication directly or indirectly inure (or are intended to inure) to or for the use of the party or candidate. On the other hand, proceeds are not considered to directly or indirectly inure to the benefit of a political party or political candidate if the benefit derived is so remote as to be negligible or merely a coincidence of the relationship of a political candidate to a trade or business profiting from an expenditure of funds. For example, the proceeds of expenditures made by a taxpayer in the ordinary course of his trade or business for advertising in a publication, such as a newspaper or
magazine, are not considered as inuring to the benefit of a political party or political candidate merely because the publication endorses a particular political candidate or candidates of a particular political party, the publisher independently contributes to the support of a political party or candidate out of his own personal funds, or the principal stockholder of the publishing firm is a candidate for public office.

(ii) Proceeds to political party. If a political party may order the disposition of any part of the proceeds of a publication or event described in paragraph (c) or (d) of this section, such proceeds inure to the use of the party regardless of what the proceeds are to be used for or that their use is restricted to a particular purpose unrelated to the election of specific candidates for public office. Accordingly, where a political party holds a dinner for the purpose of raising funds to be used in a voter registration drive, voter education program, or nonprofit political research program, partisan or nonpartisan, the proceeds are considered to directly or indirectly inure to or for the use of the political party. Proceeds may inure to or for the use of a political party even though they are to be used for purposes which may not be directly related to any particular election (such as to pay office rent for its permanent quarters, salaries to permanent employees, or utilities charges, or to pay the cost of an event such as a dinner or program as defined in paragraph (d) of this section).

(iii) Proceeds to political candidate. Proceeds directly or indirectly inure (or are intended to inure) to or for the use of a political candidate if, in addition to meeting the conditions described in subdivision (i) of this subparagraph, (a) some part of the proceeds is or may be used directly or indirectly for the purpose of furthering his candidacy for selection, nomination, or election to any elective public office, and (b) they are not received by him in the ordinary course of a trade or business (other than the trade or business of holding public office). Proceeds may so inure whether or not the expenditure sought to be deducted was paid or incurred before the commencement of political activities with respect to the selection, nomination, or election referred to in (a) of this subdivision, or after such selection, nomination, or election has been made or has taken place. For example, proceeds of an event which may be used by an individual who, under the facts and circumstances at the time of the event, the persons making expenditures in connection therewith generally believe will in the reasonably foreseeable future run for a public office, and which may be used in furtherance of such individual’s candidacy, generally will be deemed to inure (or to be intended to inure) to or for the use of a political candidate for the purpose of furthering such individual’s candidacy. Or, as another example, proceeds of an event occurring after an election, which may be used by a candidate in that election to repay loans incurred in directly or indirectly furthering his candidacy, or in reimbursement of expenses incurred in directly or indirectly furthering his candidacy, will be deemed to directly or indirectly inure (or to be intended to inure) to or for the use of a political candidate for the purpose of furthering his candidacy. For purposes of this subdivision, if the proceeds received by a candidate exceed substantially the fair market value of the goods furnished or services rendered by him, the proceeds are not received by the candidate in the ordinary course of his trade or business.

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

Example 1. Corporation O pays the Y political party $100,000 per annum for the right to publish the Y News, and retain the entire proceeds from the sale of the publication. Amounts paid or incurred for advertising in the Y News are not deductible because a part of the proceeds thereof indirectly inures to or for the use of a political party.

Example 2. The X political party holds a highly publicized ball honoring one of its active party members and admission tickets are offered to all. The guest of honor is a prominent national figure and a former incumbent of a high public office. The price of admission is designed to cover merely the cost of entertainment, food, and the ballroom, and all proceeds are paid to the hotel where the function is held, with the political
§ 1.278–1 Capital expenditures incurred in planting and developing citrus and almond groves.

(a) General rule. (1)(i) Except as provided in subparagraph (2)(iii) of this paragraph and paragraph (b) of this section, there shall be charged to capital account any amount (allowable as a deduction without regard to section 278 or this section) attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof), and which is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted. For purposes of section 278 and this section, such an amount shall be considered as “incurred” in accordance with the taxpayer’s regular tax accounting method used in reporting income and expenses connected with the citrus or almond grove operation. For purposes of this paragraph, the portion of a citrus or almond grove planted in 1 taxable year shall be treated separately from the portion of such grove planted in another taxable year. The provisions of section 278 and this section apply to taxable years beginning after December 31, 1969, in the case of a citrus grove, and to taxable years beginning after January 12, 1971, in the case of an almond grove.

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

Example 1. T, a fiscal year taxpayer plants a citrus grove 5 weeks before the close of his taxable year ending in 1971. T is required to capitalize any amount (allowable as a deduction without regard to section 278 or this section) attributable to the planting, cultivation, maintenance, or development of such grove until the close of his taxable year ending in 1974.

Example 2. Assume the same facts as in Example 1, except that T plants one portion of such grove 5 weeks before the close of his taxable year ending in 1971 and another portion of such grove at the beginning of his taxable year ending in 1972. The required capitalization period for expenses attributable to the first portion of such grove shall run until the close of T’s taxable year ending in 1974. The required capitalization period for expenses attributable to the second portion of such grove shall run until the close of T’s taxable year ending in 1975.

(2)(i) For purposes of section 278 and this section a citrus grove is defined as one or more trees of the rue family, often thorny and bearing large fruit with hard, usually thick peel and pulpy flesh, such as the orange, grapefruit, lemon, lime, citron, tangelo, and tangerine.

(ii) For purposes of section 278 and this section, an almond grove is defined as one or more trees of the species Prunus amygdalus.

(iii) An amount attributable to the cultivation, maintenance, or development of a citrus or almond grove (or part thereof) shall include, but shall not be limited to, the following developmental or cultural practices expenditures: Irrigation, cultivation, pruning, fertilizing, management fees, frost protection, spraying, and upkeep of the citrus or almond grove. The provisions of section 278(a) and this paragraph...
shall apply to expenditures for fertilizer and related materials notwithstanding the provisions of section 180, but shall not apply to expenditures attributable to real estate taxes or interest, to soil and water conservation expenditures allowable as a deduction under section 175, or to expenditures for clearing land allowable as a deduction under section 182. Further, the provisions of section 278(a) and this paragraph apply only to expenditures allowable as deductions without regard to section 278 and have no application to expenditures otherwise chargeable to capital account, such as the cost of the land and preparatory expenditures incurred in connection with the citrus or almond grove.

(iv) For purposes of section 278 and this section, a citrus or almond tree shall be considered to be "planted" on the date on which the tree is placed in the permanent grove from which production is expected.

(3)(i) The period during which expenditures described in section 278(a) and this paragraph are required to be capitalized shall, once determined, be unaffected by a sale or other disposition of the citrus or almond grove. Such period shall, in all cases, be computed by reference to the taxable years of the owner of the grove at the time that the citrus or almond trees were planted. Therefore, if a citrus or almond grove subject to the provisions of section 278 or this paragraph is sold or otherwise transferred by the original owner of the grove before the close of his fourth taxable year beginning with the taxable year in which the trees were planted, expenditures described in section 278(a) or this paragraph made by the purchaser or other transferee of the citrus or almond grove from the date of his acquisition until the close of the original holder's fourth such taxable year are required to be capitalized.

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

Example 1. T, a fiscal year taxpayer with a taxable year of July 1, 1969, through June 30, 1970, plants a citrus grove on August 1, 1969. Since the grove was planted prior to December 30, 1969, no expenses incurred with respect to the grove shall be subject to the provisions of paragraph (a).

Example 2. Assume the same facts as in Example 1, except that T plants the grove on March 1, 1970. Since the grove was planted after December 30, 1969, all amounts allowable as deductions (without regard to section 278 or this section) and attributable to the grove shall be subject to the provisions of paragraph (a). However, since paragraph (a) applies only to taxable years beginning after December 31, 1969, T must capitalize only those amounts incurred during his taxable years ending in 1971, 1972, and 1973.

§ 1.279–1 General rule; purpose.

An obligation issued to provide a consideration directly or indirectly for a corporate acquisition, although constituting a debt under section 385, may have characteristics which make it
more appropriate that the participation in the corporation which the obligation represents be treated for purposes of the deduction of interest as if it were a stockholder interest rather than a creditors interest. To deal with such cases, section 279 imposes certain limitations on the deductibility of interest paid or incurred on obligations which have certain equity characteristics and are classified as corporate acquisition indebtedness. Generally, section 279 provides that no deduction will be allowed for any interest paid or incurred by a corporation during the taxable year with respect to its corporate acquisition indebtedness to the extent that such interest exceeds:

(1) $5 million, reduced by
(2) The amount of interest paid or incurred by such corporation during such year on any obligation issued after December 31, 1967, to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) but which is not corporate acquisition indebtedness. Such an obligation is not corporate acquisition indebtedness if it:

(i) Was issued prior to October 10, 1969, or
(ii) Was issued after October 9, 1969, but does not meet any one or more of the tests of section 279(b) (2), (3), or (4), or
(iii) Was originally deemed to be corporate acquisition indebtedness but is no longer so treated by virtue of the application of paragraphs (3) or (4) of section 279(d) or
(iv) Is specifically excluded from treatment as corporate acquisition indebtedness by virtue of sections 279(d)(5), (f), or (i).

The computation of the amount by which the $5 million limitation described in this paragraph is to be reduced with respect to any taxable year is to be made as of the last day of the taxable year in which an acquisition described in section 279(b)(1) occurs. In no case shall the $5 million limitation be reduced below zero.

(b) Certain terms defined. When used in section 279 and the regulations thereunder:

(1) The term issued includes the giving of a note or other evidence of indebtedness to a bank or other lender as well as an issuance of a bond or debenture. In the case of obligations which are registered with the Securities and Exchange Commission, the date of issue is the date on which the issue is first offered to the public. In the case of obligations which are not so registered, the date of issue is the date on which the obligation is sold to the first purchaser.

(2) The term interest includes both stated interest and unstated interest (such as original issue discount as defined in paragraph (a)(1) of § 1.163–4 and amounts treated as interest under section 483).

[T.D. 7262, 38 FR 5844, Mar. 5, 1973]
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(3) The term money means cash and its equivalent.

(4) The term control shall have the meaning assigned to such term by section 368(c).

(5) The term affiliated group shall have the meaning assigned to such term by section 1504(a), except that all corporations other than the acquired corporation shall be treated as includible corporations (without any exclusion under section 1504(b)) and the acquired corporation shall not be treated as an includible corporation. This definition shall apply whether or not some or all of the members of the affiliated group file a consolidated return.

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

Example 1. On March 4, 1973, X Corporation, a calendar year taxpayer, issues an obligation which satisfies the test of section 279(b)(1) but fails to satisfy either of the tests of section 279(b)(2) or (3). Since at least one of the tests of section 279(b) is not satisfied the obligation is not corporate acquisition indebtedness. However, since the test of section 279(b)(1) is satisfied, the interest on the obligation will reduce the $5 million limitation provided by section 279(a)(1).

Example 2. On January 1, 1969, X Corporation, a calendar year taxpayer, issues an obligation, which satisfies all the tests of section 279(b), requiring it to pay $3.5 million of interest each year. Since the obligation was issued before October 10, 1969, the obligation cannot be corporate acquisition indebtedness, and a deduction for the $3.5 million of interest attributable to such obligation is not subject to disallowance under section 279(a). However, since the obligation was issued after December 31, 1967, in an acquisition described in section 279(b)(1), under section 279(a)(2) the $3.5 million of interest attributable to such obligation reduces the $5 million limitation provided by section 279(a)(1) to $1.5 million.

Example 3. Assume further that on January 1, 1970, X Corporation issues more obligations which are classified as corporate acquisition indebtedness and which require X Corporation to pay $4 million of interest each year. For 1970 the amount of interest paid or accrued on corporate acquisition indebtedness, which may be deducted is $1.5 million ($5 million maximum provided by section 279(a)(1) less $3.5 million, the reduction required under section 279(a)(2)). Thus, $2.5 million of the $4 million interest incurred on a corporate acquisition indebtedness is subject to disallowance under section 279(a) for the taxable year 1970.

Example 4. Assume the same facts as in Example 3. Assume further that on the last day of each of the taxable years 1971, 1972, and 1973 of X Corporation neither of the conditions described in section 279(b)(4) was present.

Under these circumstances, such obligations for all taxable years after 1973 are not corporate acquisition indebtedness under section 279(d)(4). Therefore, the $2.5 million of interest previously not deductible is not deductible for all taxable years after 1973. Although such obligations are no longer treated as corporate acquisition indebtedness, the interest attributable thereto must be applied in further reduction of the $5 million limitation. The $5 million limitation of section 279(a)(1) is therefore reduced to zero. While the limitation is at the zero level any interest paid or incurred on corporate acquisition indebtedness will be disallowed.

[T.D. 7262, 38 FR 5844, Mar. 5, 1973]
(ii) Assets of another corporation (referred to in section 279 and the regulations thereunder as “acquired corporation”) pursuant to a plan under which at least two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by such corporation are acquired.

The fact that the corporation that issues the obligation is not the same corporation that acquires the acquired corporation does not prevent the application of section 279. For example, if X Corporation acquires all the stock of Y Corporation through the utilization of an obligation of Z Corporation, a wholly owned subsidiary of X Corporation, this section will apply.

(2) Direct or indirect consideration. Obligations are issued to provide direct consideration for an acquisition within the meaning of section 279(b)(1) where the obligations are issued to the shareholders of an acquired corporation in exchange for stock in such acquired corporation or where the obligations are issued to the acquired corporation in exchange for its assets. The application of the provisions of this subsection relating to indirect consideration for an acquisition of stock or assets depends upon the facts and circumstances surrounding the acquisition and the issuance of the obligations. Obligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of section 279(b)(1) where (i) at the time of the issuance of the obligations the issuing corporation anticipated the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition, or where (ii) at the time of the acquisition the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.

(3) Stock acquisition. (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of stock in the acquired corporation shall be treated as a stock acquisition within the meaning of section 279(b)(1)(A). Where the stock of one corporation is acquired from another corporation and such stock constitutes at least two-thirds (in value) of all the assets (excluding money) of the latter corporation, such acquisition shall be deemed an asset acquisition as described in section 279(b)(1)(B) and subparagraph (4) of this section. If the issuing corporation acquires less than two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by the acquired corporation within the meaning of section 279(b)(1)(B) and subparagraph (4) of this paragraph and such assets include stock of another corporation, the acquisition of such stock is a stock acquisition within the meaning of section 279(b)(1)(A) and of this subparagraph. In such a case the amount of the obligation which is characterized as corporate acquisition indebtedness shall bear the same relationship to the total amount of the obligation issued as the fair market value of the stock acquired bears to the total of the fair market value of the assets acquired and stock acquired, as of the date of acquisition.

For rules with respect to acquisitions of stock, where the total amount of stock of the acquired corporation held by the issuing corporation never exceeded 5 percent of the total combined voting power of all classes of stock of the acquired corporation entitled to vote, see §1.279–4(b)(1).

(ii) If the issuing corporation acquired stock of an acquired corporation in an acquisition described in section 279(b)(1)(A), and liquidated the acquired corporation under section 334(b)(2) and the regulations thereunder before the last day of the taxable year in which such stock acquisition is made, such obligation issued to provide consideration directly or indirectly to acquire such stock of the acquired corporation shall be considered as issued in an acquisition described in section 279(b)(1)(B).

(4) Asset acquisition. (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of assets of an acquired corporation pursuant to a plan under which at least
two-thirds of the gross value of all the assets (excluding money) used in trades and businesses carried on by such acquired corporation are acquired shall be treated as an asset acquisition within the meaning of section 279(b)(1)(B). For purposes of section 279(b)(1)(B), the gross value of any acquired asset shall be its fair market value as of the day of its acquisition. In determining the fair market value of an asset, no reduction shall be made for any liabilities, mortgages, liens, or other encumbrances to which the asset or any part thereof may be subject. For purposes of this subparagraph, an asset which has been actually used in the trades and businesses of a corporation but which is temporarily not being used in such trades and businesses shall be treated as if it is being used in such manner. For purposes of this paragraph, the day of acquisition will be determined by reference to the facts and circumstances surrounding the transaction.

(ii) For purposes of the two-thirds test described in section 279(b)(1)(B), the stock of any corporation which is controlled by the acquired corporation shall be considered as an asset used in the trades and businesses of such acquired corporation.

(5) Certain nontaxable transactions. (i) Under section 279(e), an acquisition of stock of a corporation of which the issuing corporation is in control in a transaction in which gain or loss is not recognized shall be deemed an acquisition described in section 279(b)(1)(A) only if immediately before such transaction the acquired corporation was in existence, and the issuing corporation was not in control of such corporation. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g), the affiliated group shall be treated as the issuing corporation. Thus, any stock of the acquired corporation, owned by members of the affiliated group, shall be aggregated in determining whether the issuing corporation was in control of the acquired corporation.

(ii) The $5 million limitation provided by section 279(a)(1) is not reduced by the interest on an obligation issued in a transaction which, under section 279(e), is deemed not to be an acquisition described in section 279(b)(1).

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

Example 1. On January 1, 1973, W Corporation, a calendar year taxpayer, issues to the public 10,000 10 year convertible bonds each with a principal of $1,000 for $9 million. On June 6, 1973, W Corporation transfers the $9 million proceeds of such bond issue to X Corporation in exchange for X Corporation’s common stock in a transaction that satisfies the provisions of section 351(a). On December 31, 1973, W Corporation’s ratio of debt to equity is 1 1/2 to 1 and its project earnings exceed three times the annual interest to be paid or incurred. Immediately prior to the transaction between the two corporations W Corporation owned no stock in X Corporation which had been in existence for several years. However, immediately after this transaction W Corporation is in control of X Corporation. Since X Corporation, the acquired corporation, was in existence and W Corporation, the issuing corporation, was not in control of X Corporation immediately before the section 351 transaction (a transaction in which gain or loss is not recognized) and since W Corporation is now in control of X Corporation, the acquisition of X Corporation’s common stock by W Corporation is not protected from treatment as an acquisition described in section 279(b)(1)(A). However, the obligation will not be deemed to be corporate acquisition indebtedness since the test of section 279(b)(4) is not met. The interest on the obligation will reduce the $5 million limitation of section 279(a).

Example 2. Assume the facts are the same as described in Example 1, except that X Corporation was not in existence prior to June 6, 1973, but rather is newly created by W Corporation on such date. Since X Corporation, the acquired corporation, was not in existence before June 6, 1973, the date on which W Corporation, the issuing corporation, acquired control of X Corporation in a transaction on which gain or loss is not recognized, the acquisition is not deemed to be an acquisition described in section 279(b)(1)(A). Thus, under the provisions of subdivision (ii) of this subparagraph, the $5 million limitation provided by section 279(a)(1) will not be reduced by the yearly interest incurred on the convertible bonds issued by W Corporation.

Example 3. Assume that the facts are the same as described in Example 1, except that W Corporation was in control of X Corporation immediately before the transaction. Since W Corporation was in control of X Corporation immediately before the section
351(a) transaction and is in control of X Corporation after such transaction, the result will be the same as in Example 2.

(c) Subordinated obligation—(1) In general. An obligation which is issued to provide consideration for an acquisition described in section 279(b)(1) is subordinated within the meaning of section 279(b)(2) if it is either:
   (i) Subordinated to the claims of trade creditors of the issuing corporation generally, or
   (ii) Expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuing corporation, irrespective of whether such subordination relates to payment of interest, or principal, or both. In applying section 279(b)(2) and this paragraph in any case where the issuing corporation is a member of an affiliated group of corporations, the affiliated group shall be treated as the issuing corporation.

(2) Expressly subordinated obligation. In applying subparagraph (1)(ii) of this paragraph, an obligation is considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself, or in another agreement between the parties to such obligation. An obligation shall be considered to be expressly subordinated within the meaning of subparagraph (1)(ii) of this paragraph if such obligation by its terms can become subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness which is outstanding or which may be issued subsequently. However, an obligation shall not be considered expressly subordinated if such subordination occurs solely by operation of law, such as in the case of bankruptcy laws. For purposes of this paragraph, the term substantial amount of unsecured indebtedness means an amount of unsecured indebtedness equal to 5 percent or more of the face amount of the obligations issued within the meaning of section 279(b)(1).

(d) Convertible obligation. An obligation which is issued to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) is convertible within the meaning of section 279(b)(3) if it is either—(1) Convertible directly or indirectly into stock of the issuing corporation, or (2) Part of an investment unit or other arrangement which includes, in addition to such bond or other evidence of indebtedness, an option to acquire directly or indirectly stock in the issuing corporation. Stock warrants or convertible preferred stock included as part of an investment unit constitute options within the meaning of the preceding sentence. Indebtedness is indirectly convertible if the conversion feature gives the holder the right to convert into another bond of the issuing corporation which is then convertible into the stock of the issuing corporation. In any case where the corporation which in fact issues an obligation to provide consideration for an acquisition described in section 279(b)(1) is a member of an affiliated group, the provisions of section 279(b)(3) and this paragraph are deemed satisfied if the stock into which either the obligation or option which is part of an investment unit or other arrangement is convertible, directly or indirectly, is stock of any member of the affiliated group.

(e) Ratio of debt to equity and projected earnings test. For rules with respect to the application of section 279(b)(4) (relating to the ratio of debt to equity and the ratio of projected earnings to annual interest to be paid or incurred), see paragraphs (d), (e), and (f) of §1.279–5.

(f) Certain obligations issued after October 9, 1969—(1) In general. Under section 279(i), an obligation shall not be corporate acquisition indebtedness if such obligation is issued after October 9, 1969, to provide consideration for the acquisition of:
   (i) Stock or assets pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition, or
   (ii) Stock in any corporation where the issuing corporation, on October 9, 1969, and at all times thereafter before such acquisition, owned at least 50 percent of the total combined voting power of all classes of stock entitled to vote of the acquired corporation.

Subdivision (ii) of this subparagraph shall cease to apply when (at any time on or after October 9, 1969) the issuing...
corporation has acquired control of the acquired corporation. The interest attributable to any obligation which satisfies the conditions stated in the first sentence of this subparagraph shall reduce the $5 million limitation of section 279(a)(1).

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

Example 1. On September 5, 1969, M Corporation, a calendar year taxpayer, entered into a binding written contract with N Corporation to purchase 20 percent of the voting stock of N Corporation. The contract was in effect on October 9, 1969, and at all times thereafter before the acquisition of the stock on January 1, 1970. Pursuant to such contract M Corporation issued on January 1, 1970, to N Corporation an obligation which satisfies the tests of section 279(b) requiring it to pay $1 million of interest each year. However, under the provisions of subparagraph (1)(i) of this paragraph, such obligation is not corporate acquisition indebtedness since it was issued to provide consideration for the acquisition of stock pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition. The $1 million of yearly interest on the obligation reduces the $5 million limitation provided in section 279(a)(1) to $4 million since such interest is attributable to an obligation which was issued to provide consideration for the acquisition of stock in an acquired corporation.

Example 2. On October 9, 1969, O Corporation, a calendar year taxpayer, owned 50 percent of the total combined voting power of all classes of stock entitled to vote of P Corporation. P Corporation has no other class of stock. On January 1, 1970, while still owning such voting stock O Corporation issued to the shareholders of P Corporation to provide consideration for an additional 40 percent of P Corporation’s voting stock an obligation which satisfied the tests of section 279(b) requiring it to pay $4 million of interest each year. Hence, O Corporation acquired control of P Corporation, and the provisions of subparagraph (1)(ii) of this paragraph ceased to apply to O Corporation. Thus, 75 percent of the obligation issued by O Corporation to provide consideration for the stock of P Corporation is not corporate acquisition indebtedness (that is, of the 40 percent of the voting stock of P Corporation which was acquired, only 30 percent was needed to give O Corporation control). Since 25 percent of the obligation is corporate acquisition indebtedness, $1 million of interest attributable to such obligation is subject to disallowance under section 279(a) for the taxable year 1970. The remaining $3 million of interest attributable to the obligation will reduce the $5 million limitation provided by in section 279(a)(1).

(g) Exemptions for certain acquisitions of foreign corporations.—(1) In general. Under section 279(f), the term corporate acquisition indebtedness does not include any indebtedness issued to any person to provide consideration directly or indirectly for the acquisition of stock in, or assets of, any foreign corporation substantially all the income of which, for the 3-year period ending with the date of such acquisition or for such part of such period as the foreign corporation was in existence, is from sources without the United States. The interest attributable to any obligation excluded from treatment as corporate acquisition indebtedness by reason of this paragraph shall reduce the $5 million limitation of 279(a)(1).

(2) Foreign corporation. For purposes of this paragraph, the term foreign corporation shall have the same meaning as in section 7701(a)(5).

(3) Income from sources without the United States. For purposes of this paragraph, the term income from sources without the United States shall be determined in accordance with sections 862 and 863. If more than 80 percent of a foreign corporation’s gross income is derived from sources without the United States, such corporation shall be considered to be deriving substantially all of its income from sources without the United States.

[T.D. 7262, 38 FR 5845, Mar. 5, 1973]
obligation to provide consideration for an acquisition described in section 279(b)(1) in such taxable year. Thus, for example, if a corporation, reporting income on a calendar year basis, has an obligation outstanding as of December 31, 1975, which was classified as a corporate acquisition indebtedness as of the close of 1972 and such obligation would not have been classified as corporate acquisition indebtedness as of the close of 1973, 1974, and 1975 because neither of the conditions of section 279(b)(4) were present as of such dates, then such obligation shall not be corporate acquisition indebtedness for 1976 and all taxable years thereafter. Such obligation shall not be reclassified as corporate acquisition indebtedness in any taxable year following 1975, even if the issuing corporation issues more obligations (whether or not found to be corporate acquisition indebtedness) in such later years to provide consideration for the acquisition of additional stock in, or assets of, the same acquired corporation with respect to which the original obligation was issued. The interest attributable to such obligation shall reduce the $5 million limitation provided by section 279(a)(1) for 1976 and all taxable years thereafter.

(b) Five percent stock rule—(1) In general. Under section 279(d)(5), if an obligation issued to provide consideration for an acquisition of stock in another corporation meets the tests of section 279(b), such obligation shall be corporate acquisition indebtedness for a taxable year only if at sometime after October 9, 1969, and before the close of such year the issuing corporation owns or has owned 5 percent or more of the total combined voting power of all classes of stock entitled to vote in the acquired corporation. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g) the affiliated group shall be treated as the issuing corporation. Thus, any stock of the acquired corporation owned by members of the affiliated group shall be aggregated to determine if the percentage limitation provided by this subparagraph is exceeded. Once an obligation is deemed to be corporate acquisition indebtedness such obligation will continue to be deemed corporate acquisition indebtedness for all taxable years thereafter unless the provisions of section 279(d)(3) or (4) apply, notwithstanding the fact that the issuing corporation owns less than 5 percent of the combined voting power of all classes of stock entitled to vote of the acquired corporation in any or all taxable years thereafter.

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

Example 1. Corporation Y uses the calendar year as its taxable year and has only one class of stock outstanding. On June 1, 1972, X Corporation which is also a calendar year taxpayer and which has never been a shareholder of Y Corporation acquires from the shareholders of Y Corporation 4 percent of the stock of Y Corporation in exchange for obligations which satisfy the conditions of section 279(b). At no time during 1972 does X Corporation own 5 percent or more of the stock of Y Corporation. Accordingly, under the provisions of subparagraph (1) of this paragraph, for 1972 the obligations issued by X Corporation to provide consideration for the acquisition of Y Corporation’s stock do not constitute corporate acquisition indebtedness.

Example 2. Assume the same facts as in Example 1. Assume further that on February 24, 1973, X Corporation acquires from the shareholders of Y Corporation an additional 7 percent of the stock of Y Corporation in exchange for obligations which satisfy all of the tests of section 279(b). On December 28, 1973, X Corporation sells all of its stock in Y Corporation. For 1973, the obligations issued by X Corporation in 1972 and in 1973 constitute corporate acquisition indebtedness since X Corporation at some time after October 9, 1969, and before the close of 1973 owned 5 percent or more of the voting stock of Y Corporation. Furthermore, such obligations shall be corporate acquisition indebtedness for all taxable years thereafter unless the special provisions of section 279(d)(3) or (4) could apply.

(c) Changes in obligation—(1) In general. Under section 279(h), for purposes of section 279:

(i) Any extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness shall not be deemed to be the issuance of a new obligation, and

(ii) Any obligation which is corporate acquisition indebtedness of the issuing corporation is also corporate acquisition indebtedness of any corporation
which in any transaction or by operation of law assumes liability for such obligation or becomes liable for such obligation as guarantor, endorser, or indemnitor.

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

Example 1. On January 1, 1971, X Corporation, which files its return on the basis of a calendar year, issues an obligation, which satisfies the tests of section 279(b), and is deemed to be corporate acquisition indebtedness. Under section 279(d)(1), the deduction of interest expense on any obligation shall not be disallowed under section 279(a) before the first taxable year of the issuing corporation as of the last day of any taxable year of the issuing corporation, such obligation shall be corporate acquisition indebtedness as of the last day of any taxable year of the issuing corporation.

Example 2. On June 12, 1971, X Corporation, a calendar year taxpayer, issued convertible and subordinated obligations to acquire the stock of Z Corporation. The obligations were deemed corporate acquisition indebtedness on December 31, 1971. On March 4, 1973, X Corporation and Y Corporation consolidated to form XY Corporation in accordance with State law. Corporation XY is liable for the obligations issued by X Corporation by operation of law and the obligations continue to be corporate acquisition indebtedness. In 1975 XY Corporation exchanges its own nonconvertible obligations for the obligations X Corporation issued. The obligations of XY Corporation issued in exchange for those of X Corporation will be deemed to be corporate acquisition indebtedness.


§ 1.279–5 Rules for application of section 279(b).

(a) Taxable years to which applicable—

(1) First year of disallowance. Under section 279(d)(1), the deduction of interest on any obligation shall not be disallowed under section 279(a) before the first taxable year of the issuing corporation as of the last day of any taxable year of the issuing corporation. Thus, if any member of the affiliated group issues an obligation to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) of stock in, or assets of, the acquired corporation, the obligation shall be corporate acquisition indebtedness.

(2) General rule for succeeding years. Under section 279(d)(2), except as provided in paragraphs (3), (4), and (5) of section 279(d), if an obligation is determined to be corporate acquisition indebtedness as of the last day of any taxable year of the issuing corporation, such obligation shall be corporate acquisition indebtedness for such taxable year and all subsequent taxable years.

(b) Time of determination—(1) In general. The determination of whether an obligation meets the conditions of section 279(b)(1), (2), and (3) shall be made as of the day on which the obligation is issued.

(2) Ratio of debt to equity, projected earnings, and annual interest to be paid or incurred. (i) Under section 279(c)(1), the determination of whether an obligation meets the conditions of section 279(b)(4) is first to be made as of the last day of the taxable year of the issuing corporation in which it issues the obligation to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) of stock in, or assets of, the acquired corporation. An obligation which is not corporate acquisition indebtedness only because it does not satisfy the test of section 279(b)(4) in the taxable year of the issuing corporation in which the obligation is issued for stock in, or assets of, the acquired corporation may be subjected to the test of section 279(b)(4) again. A retesting will occur in any subsequent taxable year of the issuing corporation in which the issuing corporation issues any obligation to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) with respect to the same acquired corporation, irrespective of whether such subsequent obligation is itself classified as corporate acquisition indebtedness. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g) the affiliated group shall be treated as the issuing corporation. Thus, if any member of the affiliated group issues an obligation to acquire additional stock in, or assets of, the acquired corporation, this paragraph shall apply.

(ii) For purposes of section 279(b)(4) and this paragraph, in any case where the issuing corporation is a member of an affiliated group (see section 279(g) and §1.279-6 for rules regarding application of section 279 to certain affiliated
Example 1. In 1971, X Corporation, which files its Federal income tax return on the basis of a calendar year, issues its obligations to provide consideration for the acquisition of substantially all the properties of Y Corporation and Z Corporation. Y Corporation and Z Corporation each have only one class of stock. When issued, such obligations satisfied the tests prescribed in section 279(b)(1), (2), and (3) and would have constituted corporate acquisition indebtedness but for the test prescribed in section 279(b)(4). On December 31, 1971, the application of section 279(b)(4) results in X Corporation’s obligations issued in 1971 not being treated as corporate acquisition indebtedness for that year.

Example 2. Assume the same facts as in Example 1, except that in 1972, X Corporation issues more obligations which come within the tests of section 279(b)(1), (2), and (3) to acquire an additional 10 percent of the voting stock of Y Corporation. No stock of Z Corporation is acquired after 1971. The application of section 279(b)(4)(B) (relating to the projected earnings of X Corporation) as of the end of 1972 results in the obligations issued in 1972 to provide consideration for the acquisition of the stock of Y Corporation being treated as corporate acquisition indebtedness. Since X Corporation during 1972 did issue obligations to acquire more stock of Y Corporation, under the provisions of section 279(c)(1) and subparagraph (2) of this paragraph the obligations issued by X Corporation in 1971 to acquire stock in Y Corporation are again tested to determine whether the test of section 279(b)(4) with respect to such obligations is satisfied for 1972. Thus, since such obligations issued by X Corporation to acquire Y Corporation’s stock in 1971 previously came within the provisions of section 279(b)(1), (2), and (3) and the projected earnings test of section 279(b)(4)(B) is satisfied for 1972, all of such obligations are to be deemed to constitute corporate acquisition indebtedness for 1972 and subsequent taxable years. The obligations issued in 1971 to acquire stock in Z Corporation continue not to constitute corporate acquisition indebtedness.

Example 3. Assume the same facts as in Examples 1 and 2. In 1973, X Corporation issues more obligations which come within the tests of section 279(b)(1), (2), and (3) to acquire more stock (but not control) in Y Corporation. On December 31, 1973, it is determined with respect to X Corporation that neither of the conditions described in section 279(b)(4) are present. Thus, the obligations issued in 1973 do not constitute corporate acquisition indebtedness. However, the obligations issued in 1971 and 1972 by X Corporation to acquire stock in Y Corporation continue to be treated as corporate acquisition indebtedness.

Example 4. Assume the same facts as in Example 3, except that X Corporation acquires control of Y Corporation in 1973. Since X Corporation has acquired control of Y Corporation, the average annual earnings (as defined in section 279(c)(3)(B) and the annual interest to be paid or incurred (as provided by section 279(c)(4)) of both X Corporation and Y Corporation under section 279(c)(3)(A)(i) are taken into account in

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(c) Acquisition of stock or assets of several corporations. An issuing corporation which acquires stock in, or assets of, more than one corporation during any taxable year must apply the tests described in section 279(b) (1), (2), and (3) separately with respect to each obligation issued to provide consideration for the acquisition of the stock in, or assets of, each such acquired corporation. Thus, if an acquisition is made with obligations of the issuing corporation that satisfy the tests described in section 279(b) (2) and (3) and obligations that fail to satisfy such tests, only those obligations satisfying such tests need be further considered to determine whether they constitute corporate acquisition indebtedness. Those obligations which meet the test of section 279(b)(1) but which are not deemed corporate acquisition indebtedness shall be taken into account for purposes of determining the reduction in the $5 million limitation of section 279(a)(1).

(d) Ratio of debt to equity and projected earnings.—(1) In general. One of the four tests to determine whether an obligation constitutes corporate acquisition indebtedness is contained in section 279(b)(4). An obligation will meet the test of section 279(b)(4) if, as of a day determined under section 279(c)(1) and paragraph (b)(2) of this section, either:

(i) The ratio of debt to equity (as defined in paragraph (c)(1) of this section) of the issuing corporation exceeds 2 to 1, or

(ii) The projected earnings (as defined in paragraph (f) of this section) of the issuing corporation exceeds 2 to 1, or

(2) Projected earnings. The term projected earnings means the “average annual earnings” (as defined in subparagraph (3) of this paragraph) of:

(i) The issuing corporation only, if subdivision (i) of this subparagraph, does not apply, or

(ii) Both the issuing corporation and the acquired corporation, in any case where the issuing corporation as of the close of its taxable year has acquired control, or has acquired substantially all of the properties, of the acquired corporation.
For purposes of subdivision (ii) of this subparagraph, an acquisition of “substantially all of the properties” of the acquired corporation means the acquisition of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the acquired corporation immediately prior to the acquisition.

(3) Average annual earnings. (i) The term average annual earnings referred to in subparagraph (2) of this paragraph is, for any corporation, the amount of its earnings and profits for any 3-year period ending with the last day of a taxable year of the issuing corporation in which it issues any obligation to provide consideration for an acquisition described in section 279(b)(1), computed without reduction for:

(a) Interest paid or incurred,
(b) Depreciation or amortization allowed under Chapter 1 of the Code,
(c) Liability for tax under Chapter 1 of the Code, and
(d) Distributions to which section 301(c)(1) apply (other than such distributions from the acquired corporation to the issuing corporation), and reduced to an annual average for such 3-year period. For the rules to determine the amount of earnings and profits of any corporation, see section 312 and the regulations thereunder.

(ii) Except as provided for in subdivision (iii) of this subparagraph, for purposes of subdivision (i) of this subparagraph, the earnings and profits for such 3-year period shall be reduced to an annual average by dividing such earnings and profits by 36 and multiplying the quotient by 12. If a corporation was not in existence during the entire 36-month period as of the close of the taxable year referred to in subdivision (i) of this subparagraph, its average annual earnings shall be determined by dividing its earnings and profits for the period of its existence by the number of whole calendar months in such period and multiplying the quotient by 12.

(iii) Where the issuing corporation acquires substantially all of the properties of an acquired corporation, the computation of earnings and profits of such acquired corporation shall be made for the period of such corporation beginning with the first day of the 3-year period of the issuing corporation and ending with the last day prior to the date on which substantially all of the properties were acquired. In determining the number of whole calendar months for such acquired corporation where the period for determining its earnings and profits includes 2 months which are not whole calendar months and the total number of days in such 2 fractional months exceeds 30 days, the number of whole calendar months for such period shall be increased by one. Where the number of days in the 2 fractional months total 30 days or less such fractional months shall be disregarded. After the number of whole calendar months is determined, the calculation for average annual earnings shall be made in the same manner as described in the last sentence of subdivision (ii) of this subparagraph.

(e) Annual interest to be paid or incurred—(1) In general. For purposes of section 279(b)(4)(B), the term annual interest to be paid or incurred means:

(i) If subdivision (ii) of this subparagraph does not apply, the annual interest to be paid or incurred by the issuing corporation only, for the taxable year beginning immediately after the day described in section 279(c)(1), determined by reference to its total indebtedness outstanding as of such day, or
(ii) If projected earnings are determined under paragraph (d)(2)(ii) of this section, the annual interest to be paid or incurred by both the issuing corporation and the acquired corporation for 1 year beginning immediately after the day described in section 279(c)(1), determined by reference to their combined total indebtedness outstanding as of such day. However, where the issuing corporation acquires substantially all of the properties of the acquired corporation, the annual interest to be paid or incurred will be determined by reference to the total indebtedness outstanding of the issuing corporation only (including any indebtedness it assumed in the acquisition) as of the day described in section 279(c)(1). The term annual interest to be paid or incurred refers to both actual interest and unstated interest. Such unstated
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interest includes original issue discount as defined in paragraph (a)(1) of §1.163–4 and amounts treated as interest under section 483. For purposes of this paragraph and paragraph (f) of this section (relating to the ratio of debt to equity), the indebtedness of any corporation shall be determined in accordance with generally accepted accounting principles. Thus, for example, the indebtedness of a corporation includes short-term liabilities, such as accounts payable to suppliers, as well as long-term indebtedness. Contingent liabilities, such as those arising out of discounted notes, the assignment of accounts receivable, or the guarantee of the liability of another, shall be included in the determination of the indebtedness of a corporation if the contingency is likely to become a reality. In addition, the indebtedness of a corporation includes obligations issued by the corporation, secured only by property of the corporation, and with respect to which the corporation is not personally liable. See section 279(g) and § 1.279–6 for rules with respect to the computation of annual interest to be paid or incurred in regard to members of an affiliated group of corporations.

(2) Examples. The provisions of these paragraphs may be illustrated by the following examples:

Example 1. Corporation X’s earnings and profits calculated in accordance with section 279(c)(3)(B) for 1972, 1971, and 1970 respectively were $25 million, $38 million, and $28 million. The interest to be paid or incurred during the calendar year of 1973 as determined by reference to the issuing corporation’s total outstanding indebtedness as of December 31, 1972, was $10 million. By dividing the sum of the earnings and profits for the 3 years by 36 (the number of whole calendar months in the 3-year period) and multiplying the quotient by 12, the average annual earnings of X Corporation for the last 3 fiscal years ending June 30, 1973, to be paid or incurred is $30 million. Since the projected earnings exceed the annual earnings of W Corporation and Z Corporation calculated in accordance with the provisions of section 279(c)(3)(B) were $4 million for the period of September 1, 1969 to December 31, 1969, $10 million and $34 million for the calendar years of 1970 and 1971 respectively, and $2 million for the period of January 1, 1972, through February 29, 1972, or a total of $30 million. To arrive at the average annual earnings, the sum of the earnings and profits of Z Corporation calculated in accordance with the provisions of section 279(c)(3)(B) were $380 million ($1,080 million + 36×$12). The earnings and profits of W Corporation for the last 3 fiscal years ending June 30, 1972, calculated in accordance with the provisions of section 279(c)(3)(B) were $300 million, $400 million, and $380 million, respectively. The average annual earnings of W Corporation is $380 million ($1,080 million + 36×$12). The earnings and profits of Z Corporation was in existence during W Corporation’s 3-year period ending with the day prior to the date substantially all the assets were acquired and the quotient is multiplied by 12, which results in an average annual earnings of $12 million ($30 million-36×$12) for Z Corporation. The combined average annual earnings of W Corporation and Z Corporation is $572 million. The interest for the fiscal year ending June 30, 1972, to be paid or incurred by W Corporation on its outstanding indebtedness as of June 30, 1972, is $110 million. Since the projected earnings exceed the annual interest to be paid or incurred by more than three times, the obligation will not be corporate acquisition indebtedness, unless the issuing corporation’s debt to equity ratio exceeds 2 to 1.

(1) Ratio of debt to equity—(1) In general. The condition described in section 279(b)(4)(A) is present if the ratio of debt to equity of the issuing corporation exceeds 2 to 1. Under section 279(c)(2), the term ratio of debt to equity means the ratio which the total indebtedness of the issuing corporation bears to the sum of its money and all its other assets (in an amount equal to adjusted basis for determining gain) less such total indebtedness. For the meaning of the term indebtedness, see paragraph (a)(1) of this section. See section 279(g) and §1.279–6 for rules with respect to the computation of the ratio of debt to equity in regard to an affiliated group of corporations.

(2) Examples. The provisions of section 279(b)(4)(A) and this paragraph may be illustrated by the following example:

[$5 million interest to be paid or incurred × $80 million owed to X Bank]
Example 1. On June 1, 1971, X Corporation, which files its federal income tax returns on a calendar year basis, issues an obligation for $45 million to the shareholders of Y Corporation to provide consideration for the acquisition of all of the stock of Y Corporation. Such obligation has the characteristics of corporate acquisition indebtedness described in section 279(b)(2) and (3). The projected earnings of X Corporation and Y Corporation exceed 3 times the annual interest to be paid or incurred by those corporations and, accordingly, the condition described in section 279(b)(4)(B) is not present. Also, on December 31, 1971, X Corporation has total assets with an adjusted basis of $150 million (including the newly acquired stock of Y Corporation having a basis of $45 million) and total indebtedness of $90 million. Hence, X Corporation’s equity is $60 million computed by subtracting its $90 million total indebtedness from its $150 million of total assets. Since X Corporation’s ratio of debt to equity of 1.5 to 1 ($90 million of total indebtedness over $60 million equity) does not exceed 2 to 1, the condition described in section 279(b)(4)(A) is not present. Therefore, X Corporation’s obligation for $45 million is not corporate acquisition indebtedness because on December 31, 1971, neither of the conditions specified in section 279(b)(4) existed.

(g) Special rules for banks and lending or finance companies—(1) Debt to equity and projected earnings. Under section 279(c)(5), with respect to any corporation which is a bank (as defined in section 581) or is primarily engaged in a lending or finance business, the following rules are to be applied:

(i) In determining under paragraph (f) of this section the ratio of debt to equity of such corporation (or of the affiliated group of which such corporation is a member), the total indebtedness of such corporation (and the assets of such corporation) shall be reduced by an amount equal to the total indebtedness owed to such corporation which arises out of the banking business of such corporation, or out of the lending or finance business of such corporation, as the case may be;

(ii) In determining under paragraph (e) of this section the annual interest to be paid or incurred by such corporation (or by the issuing corporation and acquired corporation referred to in section 279(c)(4)(B) or by the affiliated group of corporations of which such corporation is a member), the amount of such interest (determined without regard to this subparagraph) shall be reduced by an amount which bears the same ratio to the amount of such interest as the amount of the reduction for the taxable year under subdivision (i) of this subparagraph bears to the total indebtedness of such corporation (and the assets of such corporation) reduced by the sum of the reductions described in subdivision (i) of this subparagraph for such period.

For purposes of this paragraph, the term lending or finance business means a business of making loans or purchasing or discounting accounts receivable, notes, or installment obligations. Additionally, the rules stated in this paragraph regarding the application of the ratio of debt to equity, the determination of the annual interest to be paid or incurred, and the determination of the average annual earnings also apply if the bank or lending or finance company is a member of an affiliated group of corporations. However, the rules are to be applied only for purposes of determining the debt, equity, projected earnings and annual interest of the bank or lending or finance company which then are taken into account in determining the debt to equity ratio and ratio of projected earnings to annual interest to be paid or incurred by the affiliated group as a whole. Thus, these rules are to be applied to reduce the bank’s or lending or finance corporation’s indebtedness, annual interest to be paid or incurred, and average annual earnings which are taken into account with respect to the group, but are not to reduce the indebtedness of, annual interest to be paid or incurred by, and average annual earnings of, any corporation in the affiliated group which is not a bank or a lending or finance company. In determining whether any corporation which is a member of an affiliated group is primarily engaged in a lending or finance business, only the activities of such corporation, and not those of the whole group, are to be taken into account. See §1.279-6 for the application of section 279 to certain affiliated groups of corporations.
(2) **Examples.** The provisions of this paragraph may be illustrated by the following examples:

**Example 1.** As of the close of the taxable year, X Bank has a total indebtedness of $100 million, total assets of $115 million, and $80 million is owed to X Bank by its customers. Bank X’s indebtedness is $20 million ($100 million total indebtedness less $80 million owed to the X Bank by its customers) and its assets are $35 million ($115 million total assets less $80 million owed to the bank by its customers). If its annual interest to be paid or incurred is $5 million, such amount is reduced by $4 million. Thus, X Bank’s annual interest to be paid or incurred is $1 million.

**Example 2.** Assume the same facts as in **Example 1.** X Bank has earnings and profits of $23 million for the 3-year period used to determine projected earnings. In computing the average annual earnings, the $23 million amount will be reduced by $12 million (three times the $4 million reduction of interest in **Example 1,** assuming that the reduction was the same for each year). Thus X Bank’s earnings and profits for such 3-year period are $11 million ($23 million total earnings and profits less $12 million reduction).

**§ 1.279–6 Application of section 279 to certain affiliated groups.**

(a) **In general.** Under section 279(g), in any case in which the issuing corporation is a member of an affiliated group, the application of section 279 shall be determined by treating all of the members of the affiliated group in the aggregate as the issuing corporation, except that the ratio of debt to equity of, projected earnings of, and the annual interest to be paid or incurred by any corporation (other than the issuing corporation determined without regard to this paragraph) shall be included in the determinations required under section 279(b)(4) as of any day only if such corporation is a member of the affiliated group on such day, and, in determining projected earnings of such corporation under section 279(c)(3), there shall be taken into account only the earnings and profits of such corporation for the period during which it was a member of the affiliated group. The total amount of an affiliated member’s assets, indebtedness, projected earnings, and interest to be paid or incurred will enter into the computation required by this section, irrespective of any minority ownership in such member.

(b) **Aggregate money and other assets.** In determining the aggregate money and all the other assets of the affiliated group, the money and all the other assets of each member of such group shall be separately computed and such separately computed amounts shall be added together, except that adjustments shall be made, as follows:

(1) There shall be eliminated from the aggregate money and all the other assets of the affiliated group intercompany receivables as of the date described in section 279(c)(1);

(2) There shall be eliminated from the total assets of the affiliated group any amount which represents stock ownership in any member of such group;

(3) In any case where gain or loss is not recognized on transactions between members of an affiliated group under paragraph (d)(3) of this section, the basis of any asset involved in such transaction shall be the transferor’s basis;

(4) The basis of property in a transaction to which § 1.1502–13 applies is the basis of the property determined under that section; and

(5) There shall be eliminated from the money and all the other assets of the affiliated group any other amount which, if included, would result in a duplication of amounts in the aggregate money and all the other assets of the affiliated group.

(c) **Aggregate indebtedness.** For purposes of applying section 279(c), in determining the aggregate indebtedness of an affiliated group of corporations the total indebtedness of each member of such group shall be separately determined, and such separately determined amounts shall be added together, except that there shall be eliminated from such total indebtedness as of the date described in section 279(c)(1):

(1) The amount of intercompany accounts payable,

(2) The amount of intercompany bonds or other evidences of indebtedness, and

(3) The amount of any other indebtedness which, if included, would result
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In a duplication of amounts in the aggregate indebtedness of such affiliated group.

(d) Aggregate projected earnings. In the case of an affiliated group of corporations (whether or not such group files a consolidated return under section 1501), the aggregate projected earnings of such group shall be computed by separately determining the projected earnings of each member of such group under paragraph (d) of §1.279–5, and then adding together such separately determined amounts, except that:

1. A dividend (a distribution which is described in section 301(c)(1) other than a distribution described in section 243(c)(1)) distributed by one member to another member shall be eliminated, and

2. In determining the earnings and profits of any member of an affiliated group, there shall be eliminated any amount of interest income received or accrued, and of interest expense paid or incurred, which is attributable to intercompany indebtedness,

3. No gain or loss shall be recognized in any transaction between members of the affiliated group, and

4. Members of an affiliated group who file a consolidated return shall not apply the provisions of §1.1502–18 dealing with inventory adjustments in determining earnings and profits for purposes of this section.

(e) Aggregate interest to be paid or incurred. For purposes of section 279(c)(4), in determining the aggregate annual interest to be paid or incurred by an affiliated group of corporations, the annual interest to be paid or incurred by each member of such affiliated group shall be separately calculated under paragraph (e) of §1.279–5, and such separately calculated amounts shall be added together, except that any amount of annual interest to be paid or incurred on any intercompany indebtedness shall be eliminated from such aggregate interest.

[T.D. 7262, 38 FR 5851, Mar. 5, 1973]

§ 1.280B–1 Demolition of structures.

(a) In general. Section 280B provides that, in the case of the demolition of any structure, no deduction otherwise allowable under chapter 1 of subtitle A shall be allowed to the owner or lessee of such structure for any amount expended for the demolition or any loss sustained on account of the demolition, and that the expenditure or loss shall be treated as properly chargeable to the capital account with respect to the land on which the demolished structure was located.

(b) Definition of structure. For purposes of section 280B, the term structure means a building, as defined in §1.48–1(e)(1), including the structural components of that building, as defined in §1.48–1(e)(2).

(c) Effective date. This section is effective for demolitions commencing on or after December 30, 1997.


§ 1.280C–1 Disallowance of certain deductions for wage or salary expenses.

If an employer elects to claim the targeted jobs credit under section 44B (as amended by the Revenue Act of 1978), or elects to claim the new jobs credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978), the employer must reduce its deduction for wage or salary expenses paid or incurred in the year the credit is earned by the amount allowable as credit (determined without regard to the provisions of section 53). In the case in which wages and salaries are
capitalized the amount subject to depreciation must be reduced by an amount equal to the amount of the credit (determined without regard to the provisions of section 53) in determining the depreciation deduction. In the case of an employer who uses the full absorption method of inventory costing under § 1.471–11, the portion of the basis of the inventory attributable to the wage or salary expenses giving rise to the credit paid or incurred in the year the credit is earned must be reduced by the amount of the credit allowable (determined without regard to the provisions of section 53). If the employer is an organization that is under common control (as described in § 1.52–1), it must reduce its deduction for the wage and salary expenses by the amount of the credit apportioned to it under § 1.52–1 (a) or (b). The deduction for wage and salary expenses must be reduced in the year the credit is earned, even if the employer is unable to use the credit in that year because of the limitations imposed by section 53.


[T.D. 7921, 48 FR 52908, Nov. 23, 1983]

§ 1.280C–3 Disallowance of certain deductions for qualified clinical testing expenses when section 28 credit is allowable.

(a) In general. If a taxpayer is entitled to a credit under section 28 for qualified clinical testing expenses (as defined in section 28(b)), it must reduce the amount of any deduction for qualified clinical testing expenses paid or incurred in the year the credit is earned by the amount allowable as credit for such expenses (determined without regard to section 28(d)(2)).

(b) Capitalization of qualified clinical testing expenses. In a case in which qualified clinical testing expenses are capitalized, the amount chargeable to the capital account for a taxable year must be reduced by the excess of the amount of the credit allowable for the taxable year under section 28 (determined without regard to section 28(d)(2)) over the amount allowable as a deduction for qualified clinical testing expenses (determined without regard to paragraph (a) of this section) for the taxable year. See section 174 and the regulations thereunder.

(c) Controlled group of corporations; organizations under common control. In the case of a taxpayer described in paragraph (d)(5) of § 1.29–1 of this chapter (relating to controlled groups of corporations and organizations under common control), paragraphs (a) and (b) of this section shall be applied in accordance with the rules prescribed for aggregation of expenditures under that paragraph.

(d) Example. The following example illustrates the application of paragraphs (a) and (b) of this section:

Example. A incurs $1,000 in clinical testing expenses for which a $500 credit is allowable under section 28. A also elects under section 174 of the Code to amortize these expenses over a 5-year period beginning in the year the credit is claimed. Under paragraph (a), the current year amortization deduction of $200 ($1,000–$500) is disallowed. Moreover, the amount which would otherwise be capitalized, $800, is reduced by the excess of the amount of the section 28 credit claimed for the taxable year over the amount of the allowable section 174 amortization deduction for the taxable year, or $300 ($500–$200). Thus, the amount chargeable to the capital account for the taxable year is $500 ($800–$300). A is entitled to amortize $500 over the remaining amortization period resulting in a deduction of $125 for each of the remaining four years.


§ 1.280C–4 Credit for increasing research activities.

(a) In general. An election under section 280C(c)(3) to have the provisions of section 280C(c)(1) and (c)(2) not apply and elect the reduced research credit under section 280C(c)(3)(B) shall be made on Form 6765, “Credit for Increasing Research Activities” (or any successor form). In order for the election to be effective, the Form 6765 must clearly indicate the taxpayer’s intent to make the section 280C(c)(3) election, and must be filed with an original return for the taxable year filed on or before the due date (including extensions) for filing the income tax return for such year, regardless of whether any research credits are claimed on the original return. An election, once made for any taxable year, is irrevocable for that taxable year.
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(b) Controlled groups of corporations; trades or businesses under common control—(1) In general. A member of a controlled group of corporations (within the meaning of section 41(f)(5)), or a trade or business which is treated as being under common control with other trades or businesses (within the meaning of section 41(f)(1)(B)), may make the election under section 280C(c)(3). However, only the common parent (within the meaning of § 1.1502–7(a)(1)(i)) of a consolidated group may make the election on behalf of the members of a consolidated group. A member or trade or business shall make the election on Form 6765 and by the time prescribed in paragraph (a) of this section.

(2) Example. The following example illustrates an application of paragraph (b) of this section:

Example. A, B, and C, all of which are calendar year taxpayers, are members of a controlled group of corporations (within the meaning of section 41(f)(5)). A, B, and C each attach a statement to the 2009 Form 6765, “Credit for Increasing Research Activities,” showing A and C had stand-alone entity credits (within the meaning of § 1.41–6(c)(2)) that exceeded the group credit (within the meaning of § 1.41–6(a)(4)(iv)). A and C report their allocated portions of the group credit (as determined under § 1.41–6(c)) on the 2009 Form 6765 and B reports no research credit on the 2009 Form 6765. A and B, but not C, each make an election for the reduced credit on the 2009 Form 6765. In December 2010, A determines that it understated its qualified research expenses in 2009 resulting in the group credit exceeding the sum of the stand-alone credits. On an amended 2009 Form 6765, A, B, and C each report their allocated portions of the group credit (including the excess group credit). C may not reduce its credit under section 280C(c)(3)(B) because C did not make an election for the reduced credit with its original return.

(c) Effective/applicability date. This section applies to taxable years ending on or after July 27, 2011. [T.D. 9539, 76 FR 44801, July 27, 2011]

§ 1.280F–1T Limitations on investment tax credit and recovery deductions under section 168 for passenger automobiles and certain other listed property; overview of regulations (temporary).

(a) In general. Section 280F(a) limits the amount of investment tax credit determined under section 41(a) and recovery deductions under section 168 for passenger automobiles. Section 280F(b) denies the investment tax credit and requires use of the straight line method of recovery for listed property that is not predominantly used in a qualified business use. In certain circumstances, section 280F(b) requires the recapture of an amount of cost recovery deductions previously claimed by the taxpayer. Section 280F(c) provides that lessees are to be subject to restrictions substantially equivalent to those imposed on owners of such property under section 280F (a) and (b). Section 280F(d) provides definitions and special rules; note that section 280F(d)(2) and (3) apply with respect to all listed property, even if the other provisions of section 280F do not affect the treatment of the property.

(b) Key to Code provisions. The following table identifies the provisions of section 280F under which regulations are provided, and lists each provision below with its corresponding regulation section:

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<tr>
<th>Section 1.280F–2T</th>
<th>Section 1.280F–3T</th>
<th>Section 1.280F–4T</th>
<th>Sections 1.280F–5T and 1.280F–7</th>
<th>Section 1.280F–6</th>
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Sections 1.280F–2T(f) and 1.280F–4T(b) also provide special rules for improvements to passenger automobiles and other listed property that qualify as capital expenditures.

(c) Effective dates—(1) In general. This section and §§ 1.280F–2T through 1.280F–6 apply to property placed in service or leased after June 18, 1984, in taxable years ending after that date. Section 1.280F–7 applies to property leased after
December 31, 1986, in taxable years ending after that date.

(2) Exception. This section and §§1.280F–2T through 1.280F–6 shall not apply to any property:

(i) Acquired pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter, or under construction by the taxpayer on that date, but only if the property is placed in service before January 1, 1985 (January 1, 1987, in the case of 15-year real property), or

(ii) Leased pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter, but only if the lessee first uses such property under the lease before January 1, 1985 (January 1, 1987, in the case of 15-year real property).

(3) Leased passenger automobiles. Section 1.280F–5T(e) generally applies to passenger automobiles leased after April 2, 1985, and before January 1, 1987, in taxable years ending after April 2, 1985. Section 1.280F–5T(e) generally applies to passenger automobiles leased after April 2, 1985, in taxable years ending after that date. Section 1.280F–5T(e) does not apply to any passenger automobile that is leased pursuant to a binding contract, which is entered into no later than April 2, 1985, and which is in effect at all times thereafter, but only if the automobile is used under the lease before August 1, 1985. If §1.280F–5T(e) does not apply to a passenger automobile that is leased pursuant to a binding contract, which is entered into no later than April 2, 1985, and which is in effect at all times thereafter, but only if the automobile is used under the lease before August 1, 1985. If §1.280F–5T(e) does not apply to a passenger automobile, see paragraph (c) (1) and (2) of this section. Section 1.280F–7(a) applies to passenger automobiles leased after December 31, 1986, in taxable years ending after that date.


§1.280F–2T Limitations on recovery deductions and the investment tax credit for certain passenger automobiles (temporary).

(a) Limitation on amount of investment tax credit—(1) General rule. The amount of the investment tax credit determined under section 46(a) for any passenger automobile shall not exceed $1,000. For a passenger automobile placed in service after December 31, 1984, the $1,000 amount shall be increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which the automobile is placed in service.

(2) Election of reduced investment tax credit. If the taxpayer elects under section 48(q)(4) to reduce the amount of the investment tax credit in lieu of adjusting the basis of the passenger automobile under section 48(q)(1), the amount of the investment tax credit for any passenger automobile shall not exceed two-thirds of the amount determined under paragraph (a)(1) of this section.

(b) Limitations on allowable recovery deductions—(1) Recovery deduction for year passenger automobile is placed in service. For the taxable year that a taxpayer places a passenger automobile in service, the allowable recovery deduction under section 168(a) shall not exceed $4,000. See paragraph (b)(3) of this section for the adjustment to this limitation.

(2) Recovery deduction for remaining taxable years during the recovery period. For any taxable year during the recovery period remaining after the year that the property is placed in service, the allowable recovery deduction under section 168(a) shall not exceed $6,000. See paragraph (b)(3) of this section for the adjustment to this limitation.

(3) Adjustment to limitation by reason of automobile price inflation adjustment. The limitations on the allowable recovery deductions prescribed in paragraph (b) (1) and (2) of this section are increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which the automobile is placed in service.

(4) Coordination with section 179. For purposes of section 280F(a) and this section, any deduction allowable under section 179 (relating to the election to expense certain depreciable trade or business assets) is treated as if that deduction were a recovery deduction under section 168. Thus, the amount of the section 179 deduction is subject to the limitations described in paragraph (b) (1) and (2) of this section.

(c) Disallowed recovery deductions allowed for years subsequent to the recovery
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period—(1) In general. (i) Except as otherwise provided in this paragraph (c), the “unrecovered basis” (as defined in paragraph (c)(1)(ii) of this section) of any passenger automobile is treated as a deductible expense in the first taxable year succeeding the end of the recovery period.

(ii) The term unrecovered basis means the excess (if any) of:

(A) The unadjusted basis (as defined in section 168(d)(1)(A)), except that there is no reduction by reason of an election to expense a portion of the basis under section 179) of the passenger automobile, over

(B) The amount of the recovery deductions (including any section 179 deduction elected by the taxpayer) which would have been allowable for taxable years in the recovery period (determined after the application of section 280F (a) and paragraph (b) of this section and as if all use during the recovery period were used described in section 168(c)(1)).

(2) Special rule when taxpayer elects to use the section 168(b)(3) optional recovery percentages. If the taxpayer elects to use the optional recovery percentages under section 168(b)(3) or must use the straight line method over the earnings and profits life (as defined and described in § 1.280F–3T(f)), the second succeeding taxable year after the end of the recovery period is treated as the first succeeding taxable year after the end of the recovery period for purposes of section 168(c)(1) because of the half-year convention. For example, assume a calendar-year taxpayer places in service on July 1, 1984, a passenger automobile (i.e., 3-year recovery property) and elects under section 168(b)(3) to recover its cost over 5 years using the straight line optional percentages. Based on these facts, calendar year 1990 is treated as the first succeeding taxable year after the end of the recovery period.

(3) Deduction limited to $6,000 for any taxable year. The amount that may be treated as a deductible expense under this paragraph (c) in the first taxable year succeeding the recovery period shall not exceed $6,000. Any excess shall be treated as an expense for the succeeding taxable years. However, in no event may any deduction in a succeeding taxable year exceed $6,000. The limitation on amounts deductible as an expense under this paragraph (c) with respect to any passenger automobile is increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which such automobile is placed in service.

(4) Deduction treated as a section 168 recovery deduction. Any amount allowable as an expense in taxable years after the recovery period by reason of this paragraph (c) shall be treated as a recovery deduction allowable under section 168. However, a deduction is allowable by reason of this paragraph (c) with respect to any passenger automobile for a taxable year only to the extent that a deduction under section 168 would be allowable with respect to the automobile for that year. For example, no recovery deduction is allowable for a year during which a passenger automobile is disposed of or is used exclusively for personal purposes.

(5) Additional reduction in limitations by reason of personal use of passenger automobile or by reason of a short taxable year. See paragraph (i) of this section for rules regarding the additional reduction in the limitations prescribed by paragraphs (a) through (c) of this section by reason of the personal use of a passenger automobile or by reason of a short taxable year.

(e) Examples. The provisions of paragraphs (a) through (c) of this section may be illustrated by the following examples. For purposes of these examples, assume that all taxpayers use the calendar year and that no short taxable years are involved.

Example 1. (i) On July 1, 1984, B purchases for $45,000 and places in service a passenger automobile which is 3-year recovery property under section 168. In 1984, B does not elect under section 179 to expense a portion of the cost of the automobile. The automobile is used exclusively for B’s business during taxable years 1984 through 1990.

(ii) The maximum amount of B’s investment tax credit is $1,000 (i.e., the lesser of $1,000 or .06×$45,000). B’s unadjusted basis for purposes of section 168 is $44,500 (i.e., $45,000 reduced under section 49(q)(1) by $500). B elects the use of the accelerated recovery percentages under section 168(b)(1).

(iii) The maximum amount of B’s recovery deduction for 1984 is $4,000 (i.e., the lesser of $4,000 or .25×$44,500); for 1985, $6,000 (i.e., the

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lesser of $6,000 or .38×$44,500); and for 1986, $6,000 (i.e., the lesser of $6,000 or .37×$44,500).  
(iv) At the beginning of taxable year 1987, B’s unrecovered basis in the automobile is $29,500. Under paragraph (c) of this section, B may expense $6,000 of the unrecovered basis in the automobile in 1987. This expense is treated as a recovery deduction under section 168. For taxable years 1988 through 1990, B may deduct $6,000 of the unrecovered basis per year. At the beginning of 1991, B’s unrecovered basis in the automobile is $14,700. During that year, B disposes of the automobile. B is not allowed a deduction for 1991 because no deduction would be allowable under section 168 based on these facts.

Example 2.  
(i) On July 1, 1984, C purchases for $50,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in C’s business during taxable years 1984 through 1992. In 1984, C does not elect under section 179 to expense a portion of the automobile’s cost. C elects under section 168(b)(3) based on a 5-year recovery period. The maximum amount of C’s investment tax credit is $666.67 (i.e., the lesser of .06×$50,000). C’s unrecovered basis for purposes of section 168 is $50,000. C elects to use the optional recovery percentages under section 168(b)(3) based on a 5-year recovery period. 
(ii) The maximum amount of C’s recovery deduction for 1984 is $4,000 (i.e., the lesser of $4,000 or .37×$50,000); for taxable years 1985 through 1988, $6,000 per year (i.e., the lesser of $6,000 or .20×$50,000). C’s unrecovered basis in the automobile in 1990, which is the beginning of taxable year 1990, C’s unrecovered basis in the automobile is $17,000. Under paragraph (c) of this section, C may expense $6,000 of the unrecovered basis in the automobile in 1990, this expense is treated as a recovery deduction under section 168. For taxable years 1991 and 1992, C may deduct $5,000, and $5,000, respectively of the unrecovered basis. 

Example 3. Assume the same facts as in Example 2, except that C disposes of the passenger automobile on July 1, 1990. Under paragraph (c) of this section, C is not allowed a deduction for 1990 or for any succeeding taxable year because no deduction would be allowable under section 168 based on these facts.

Example 4.  
(i) On July 1, 1984, G purchases for $35,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in G’s business during taxable years 1984 through 1987. In 1984, G elects under section 179 to expense $5,000 of the cost of the property.

(ii) The maximum amount of G’s investment tax credit is $600 (i.e., the lesser of .06×$10,000 or $1,000).

(iii) G’s unrecovered basis for purposes of section 168 is $9,700 (i.e., $15,000 minus the sum of $5,000 (the amount of the expense elected under section 179) and $300 (one-half of the investment tax credit under section 48(q)(1))). Under paragraph (b)(4) of this section, the allowable deduction under section 179 is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of G’s section 179 deduction is $4,000 (i.e., the lesser of $4,000 or $5,000+.25×$10,000). G is entitled to no further recovery deduction under section 168 for 1984. The amount of G’s section 168 recovery deductions are $3,686 (i.e., the lesser of .38×$9,700 or $6,000) and $3,589 (i.e., the lesser of .37×$9,700 or $6,000), respectively. At the beginning of 1987, G’s unrecovered basis in the automobile is $3,425 (i.e., $14,700−$11,275). Under paragraph (c) of this section, G may expense the remaining $3,425 in 1987.

Example 5.  
(i) On July 1, 1984, D purchases for $55,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in D’s business during taxable years 1984 through 1993. In 1984, D elects under section 179 to expense $5,000 of the cost of the property.

(ii) The maximum amount of D’s investment tax credit is $1,000 (i.e., the lesser of $1,000 or .06×$50,000).

(iii) D’s unrecovered basis for purposes of section 168 is $49,500 (i.e., $55,000 minus the sum of $5,000 (the amount of the expense elected under section 179) and $300 (one-half of the investment tax credit under section 48(q)(1))). Under paragraph (b)(4) of this section, the allowable deduction under section 179 is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of D’s section 179 deduction is $4,000 (i.e., the lesser of $4,000 or $5,000+.25×$55,000). D is entitled to no further recovery deduction under section 168 for 1984. The amount of D’s section 168 recovery deductions are $3,686 (i.e., the lesser of .38×$9,700 or $6,000) and $3,589 (i.e., the lesser of .37×$9,700 or $6,000), respectively. At the beginning of 1987, D’s unrecovered basis in the automobile is $3,425 (i.e., $14,700−$11,275). Under paragraph (c) of this section, D may expense the remaining $3,425 in 1987.

Example 6.  
(i) On July 1, 1984, F purchases for $44,500 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in F’s business during taxable years 1984 through 1987. In 1984, F elects under section 179 to expense $5,000 of the cost of the property.

(iv) At the beginning of 1987, D’s unrecovered basis is $36,500. D may expense the remaining unrecovered basis at the rate of $6,000 per year through 1992 and $2,500 in 1993.

Example 6. Assume the same facts as in Example 5, except that in 1993, D uses the automobile only 60 percent in his business. Under paragraph (c)(4) of this section for 1993, D may expense $1,500 (i.e., .60×$2,500). D is entitled to no further deductions with respect to the automobile in any later year.

Example 7.  
(i) On July 1, 1984, F purchases for $44,500 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is

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used exclusively in F’s business during taxable years 1984 through 1992. In 1984, F elects under section 179 to expense $5,000 of the cost of the property.

(ii) F elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48(q)(1) basis adjustment. The maximum amount of F’s investment tax credit is $996.67 (i.e., the lesser of 2⁄3 of $1,000 or 0.10 × $39,500).

(iii) F’s unadjusted basis for purposes of section 168 is $39,500 (i.e., $44,500 – $5,000 (the amount of the expense elected under section 179)). F elects to use the optional recovery percentage under section 168(b)(3) based on a 5-year recovery period. Under paragraph (b)(4) of this section, the allowable section 179 deduction is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of F’s section 179 deduction is $4,000 (i.e., the lesser of $4,000 or $5,000 + 0.10 × $39,500). F is entitled to no further recovery deduction under section 168 for 1984. The maximum amounts of F’s recovery deductions for 1985 through 1988 are $5,000 per year (i.e., the lesser of $6,000 or 20 × $39,500). F’s recovery deduction for 1989 (the first taxable year after the 5-year recovery period but the sixth recovery year for purposes of section 168) is $3,950 (i.e., the lesser of 10 × $39,500 or $6,000).

(iv) Under paragraph (c), taxable year 1990 is considered to be the first taxable year succeeding the end of the recovery period. At the beginning of taxable year 1990, F’s unrecovered basis in the automobile is $12,550 (i.e., $44,500 – $31,950). Under paragraph (c), F may expense $6,000 of his unrecovered basis in the automobile in 1990 and in 1991. This expense is treated as a recovery deduction under section 168. For taxable year 1992, F may expense the remaining $550 of his unrecovered basis in the automobile.

(f) Treatment of improvements that qualify as capital expenditures. An improvement to a passenger automobile that qualifies as a capital expenditure under section 263 is treated as a new item of recovery property placed in service in the year the improvement is made. However, the limitations in paragraph (b) of this section on the amount of recovery deductions allowable are determined by taking into account a whole both the improvement and the property of which the improvement is a part. If that improvement also qualifies as an investment in new section 38 property under section 48(b) and §1.48–2(b)(2), the limitation in paragraph (a)(1) of this section on the amount of the investment tax credit for that improvement is determined by taking into account any investment tax credit previously allowed for the passenger automobile (including any prior improvement considered part of the passenger automobile). Thus, the maximum credit allowable for the automobile (including the improvement) will be $1,000 (or 2⁄3 of $1,000, in the case of an election to take a reduced credit under section 48(q)(4)) (adjusted under section 280F(d)(7) to reflect the automobile price inflation adjustment for the year the property of which the improvement is a part is placed in service).

(g) Treatment of section 1031 or section 1033 transactions—(1) Treatment of exchanged passenger automobile. For a taxable year in which a transaction described in section 1031 or section 1033 occurs, the unadjusted basis of an exchanged or converted passenger automobile shall cease to be taken into account in determining any recovery deductions allowable under section 168 as of the beginning of the taxable year in which the exchange or conversion occurs. Thus, no recovery deduction is allowable for the exchanged or converted automobile in the year of the exchange or conversion.

(2) Treatment of acquired passenger automobile—(i) In general. The acquired automobile is treated as new property placed in service in the year of the exchange (or in the replacement year) and that year is its first recovery year.

(ii) Limitations on recovery deductions. If the exchanged (or converted) automobile was acquired after the effective date of section 280F (as set out in §1.280F–1(c)), the basis of that automobile as determined under section 1031(d) or section 1033(b) (whichever is applicable) must be reduced for purposes of computing recovery deductions with respect to the acquired automobile (but not for purposes of determining the amount of the investment tax credit and gain or loss on the sale or other disposition of the property) by the excess (if any) of:

(A) The sum of the amounts that would have been allowable as recovery deductions with respect to the exchanged (or converted) automobile during taxable years preceding the year of the exchange (or conversion) if all of the use of the automobile during those
years was use described in section 168(c), over
(B) The sum of the amounts allowable as recovery deductions during those years.

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

Example 1. (i) In 1982, F purchases and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in F's business.

(ii) On July 1, 1984, F exchanges the passenger automobile and $1,000 cash for a new passenger automobile ("like kind" property). Under paragraph (g)(1) of this section, no recovery deduction is allowed in 1984 for the exchanged automobile. Any investment tax credit claimed with respect to that automobile is subject to recapture under section 47.

(iii) F's basis in the acquired property (as determined under section 1031(d) and F's qualified investment are $20,000. Under the provisions of paragraph (g)(2)(i) of this section, the acquired property is treated as new recovery property placed in service in 1984 to the extent of the full $20,000 of basis. The maximum amount of F's investment tax credit is limited to $1,000 (i.e., the lesser of $1,000 or .06×$20,000). Cost recovery deductions are computed pursuant to paragraph (b) of this section.

Example 2. (i) On July 1, 1984, E purchases for $30,000 and places in service a passenger automobile which is 3-year recovery property under section 168. In 1984, E's business use percentage is 80 percent and such use constitutes his total business/investment use.

(ii) E elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48 (q)(1) basis adjustment. The maximum amount of E's investment tax credit is $533.33 (i.e., the lesser of 8% of $1,000×.04 or .30×$30,000).

(iii) E's unadjusted basis for purposes of section 168 is $30,000. E selects the use of the accelerated recovery percentages under section 168(b)(1). The maximum amount of E's recovery deduction for 1984 is $3,200 (i.e., the lesser of $30,000×.06 or $1,800). The maximum amount of E's investment tax credit is $1,000 (i.e., the lesser of $1,000 or .06×$20,000).

(iv) On June 10, 1985, E exchanges the passenger automobile and $1,000 cash for a new passenger automobile ("like kind" property). Under paragraph (g)(1) of this section, no recovery deduction is allowable in 1985 for the exchanged automobile. The investment tax credit claimed is subject to recapture under section 47. Under paragraph (g)(2)(i) of this section, E's basis in the acquired property for purposes of computing recovery deductions under section 280F is $27,000 (i.e., $27,800 (section 1031(d) basis)−$800). The acquired automobile is used exclusively in F's business during taxable years 1985 through 1988. Under paragraph (g)(2) of this section, the acquired property is treated as new recovery property placed in service in 1985. Assume that the automobile price inflation adjustment (as described under section 280F(d)(7)) is zero. E's qualified investment in the property, as determined under §1.46-3(c)(1), is $27,800. The maximum amount of E's investment tax credit is $1,000 (i.e., the lesser of $1,000 or .06×$27,800). E's unadjusted basis for purposes of section 168 is $26,500 (i.e., $27,000 reduced under section 48(q)(1) by $500). Cost recovery deductions are computed pursuant to paragraph (b) of this section.

(h) Other nonrecognition transactions. [Reserved]

(i) Limitation under this section applies before other limitations—(1) Personal use. The limitations imposed upon the maximum amount of the allowable investment tax credit and the allowable recovery deductions (as described in paragraphs (a) through (c) of this section) must be adjusted during any taxable year in which a taxpayer makes any use of a passenger automobile other than for business/investment use (as defined in §1.280F–6(d)(3)). The limitations on the amount of the allowable investment tax credit (as described in paragraph (a) of this section) and the allowable cost recovery deductions (as described in paragraphs (b) and (c) of this section) are redetermined by multiplying the limitations by the percentage of business/investment use (determined on an annual basis) during the taxable year.

(2) Short taxable year. The limitations imposed upon the maximum amount of the allowable recovery deductions (as described in paragraphs (a) through (c) of this section) must be adjusted during any taxable year in which a taxpayer has a short taxable year. In this case, the limitation is adjusted by multiplying the limitation that would have been applied if the taxable year were not a short taxable year by a fraction, the numerator of which is the number of months and part-months in the short taxable year and the denominator of which is 12.

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

Example 1. On July 1, 1984, A purchases and places in service a passenger automobile and
uses it 80 percent for business/investment use during 1984. Under paragraph (1)(1) of this section, the maximum amount of the investment tax credit that A may claim for the automobile is $600 (i.e., .80 × $4,000).

Example 2. Assume the same facts as in Example 1, except that A elects under section 46(q)(4) to take a reduced investment tax credit in lieu of the section 46(q)(1) basis adjustment. Under paragraph (1)(1) of this section, the maximum amount of the investment tax credit that A may claim for the automobile is $533.33 (i.e., .80 × $6,666.67).

Example 3. On July 1, 1984, B purchases and places in service a passenger automobile and uses it 70 percent for business/investment use during 1984. Under paragraph (1)(1) of this section, the maximum amount of the investment tax credit that B may claim for the automobile is $600 (i.e., .70 × $4,000). B uses the car 70 percent for business/investment use during 1985 and 80 percent during 1986. Under paragraph (1)(1) of this section, the maximum amount of recovery deductions that B may claim for 1984, 1985, and 1986 are $2,400 (i.e., .70 × $4,000), $4,200 (i.e., .80 × $5,000), and $4,800 (i.e., .80 × $5,000), respectively.

Example 4. Assume the same facts as in Example 3 with the added facts that B’s unrecovered basis at the beginning of 1987 is $5,000, and that B uses the automobile 85 percent for business/investment use during 1987. Under paragraph (1)(1) of this section, the maximum amount that B may claim as an expense for 1987 is $5,000 (i.e., .85 × $6,000).

Example 5. On August 1, 1984, C purchases a passenger automobile and uses it exclusively for business. Taxable year 1984 for C is a short taxable year which consists of 6 months. Under paragraph (1)(1) of this section, the maximum amount that C may claim as a recovery deduction for 1984 is $3,000 (i.e., .50 × $6,000).

Example 6. Assume the same facts as in Example 5, except that C uses the passenger automobile 70 percent for business/investment use during 1984. Under paragraph (1)(1) and (2) of this section, the maximum amount that C may claim as a recovery deduction for 1984 is $1,400 (i.e., .70 × $6,000).


§ 1.280F–3T Limitations on recovery deductions and the investment tax credit when the business use percentage of listed property is not greater than 50 percent (temporary).

(a) In general. Section 280F(b), generally, imposes limitations with respect to the amount allowable as an investment tax credit under section 46(a) and the amount allowable as a recovery deduction under section 168 in the case of listed property (as defined in §1.280F–6(b)) if certain business use of the property (referred to as “qualified business use”) does not exceed 50 percent during a taxable year. Qualified business use generally means use in a trade or business, rather than use in an investment or other activity conducted for the production of income within the meaning of section 212. See §1.280F–6(d) for the distinction between “business/investment use” and “qualified business use.”

(b) Limitation on the amount of investment tax credit—(1) Denial of investment tax credit when business use percentage not greater than 50 percent. Listed property is not treated as section 38 property to any extent unless the business use percentage (as defined in section 280F(d)(6) and §1.280F–6(d)(1)) is greater than 50 percent. For example, if a taxpayer uses listed property in a trade or business in the taxable year in which it is placed in service, but the business use percentage is not greater than 50 percent, no investment tax credit is allowed for that listed property. If, in the taxable year in which listed property is placed in service, the only business/investment use (as defined in §1.280F–6(d)(1)) of that property is qualified business use (as defined in §1.280F–6(d)(2)(i)), and the business use percentage is 55 percent, the investment tax credit is allowed for the 55 percent of the listed property that is treated as section 38 property. The credit allowed is unaffected by any increase in the business use percentage in a subsequent taxable year.

(2) Recapture of investment tax credit. Listed property ceases to be section 38 property to the extent that the business/investment use (as defined in §1.280F–6(d)(3)) for any taxable year is less than the business/investment use for the taxable year in which the property is placed in service. See §1.47–2(c). If the business use percentage (as defined in §1.280F–6(d)(1)) of listed property is greater than 50 percent for the taxable year in which the property is placed in service, and less than or equal to 50 percent for any subsequent taxable year, that property ceases to...
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be section 38 property in its entirety in that subsequent taxable year. Under § 1.47–1(c)(1)(ii)(b), the property (or a portion thereof) is treated as ceasing to be section 38 property on the first day of the taxable year in which the cessation occurs.

(c) Limitation on the method of cost recovery under section 168 when business use of property not greater than 50 percent—(1) Year of acquisition. If any listed property (as defined in § 1.280F–6(b)) is not predominantly used in a qualified business use (as defined in § 1.280F–6(d)(4)) in the year it is acquired, the recovery deductions allowed under section 168 for the property for that taxable year and for succeeding taxable years are to be determined using the straight line method over its earnings and profits life (as defined in paragraph (f) of this section). Additionally, the taxpayer is not entitled to make any election under section 179 with respect to the property for that year.

(2) Subsequent years. If any listed property is not subject to paragraph (c)(1) of this section because such property is predominantly used in a qualified business use (as defined in § 1.280F–6(d)(4)) during the year it is acquired but is not predominantly used in a qualified business use during a subsequent taxable year, the rules of this paragraph (c)(2) apply. In such a case, the taxpayer must determine the recovery deductions allowed under section 168 for the taxable year that the listed property is not predominantly used in a qualified business use and for any subsequent taxable year as if such property was not predominantly used in a qualified business use and for any subsequent taxable year as if such property was not predominantly used in a qualified business use in the year in which it was acquired and there had been no section 179 election with respect to the property. Thus, the recovery deductions allowable under section 168 for the taxable year that the listed property is not predominantly used in a qualified business use and for any subsequent taxable year as if such property was not predominantly used in a qualified business use in the year in which it was acquired and there had been no section 179 election with respect to the property. The recovery deductions allowable under section 168 for the taxable year that the listed property is not predominantly used in a qualified business use and for any subsequent taxable year as if such property was not predominantly used in a qualified business use in the year in which it was acquired and there had been no section 179 election with respect to the property. Thus, the recovery deductions allowable under section 168 for the remaining taxable years are computed by determining the applicable recovery percentage that would apply if the taxpayer had used the straight line method over the property’s earnings and profits life beginning with the year the property was placed in service.

(3) Effect of rule on recovery property that is not listed property. The mandatory use of the straight line method over the property’s earnings and profits life under paragraphs (d) (1) and (2) of this section does not have any effect on the proper method of cost recovery for other recovery property of that same class placed in service in the same taxable year by the taxpayer and does not constitute an election to use an optional recovery period under section 168(b)(3).

(d) Recapture of excess recovery deductions claimed—(1) In general. If paragraph (c)(2) of this section is applicable, any excess depreciation (as defined in paragraph (d)(2) of this section) must be included in the taxpayer’s gross income and added to the property’s adjusted basis for the first taxable year in which the property is not predominantly used in a qualified business use (as defined in § 1.280F–6(d)(4)).

(2) Definition of excess depreciation. For purposes of this section, the term excess depreciation means the excess (if any) of:

(i) The amount of the recovery deductions allowable with respect to the property for taxable years before the first taxable year in which the property was not predominantly used in a qualified business use, over

(ii) The amount of the recovery deductions which would have been allowable for those years if the property had not been predominantly used in a qualified business use for the year it was acquired and there had been no section 179 election with respect to the property.

For purposes of paragraph (d)(2)(i), any deduction allowable under section 179 (relating to the election to expense certain depreciable trade or business assets) is treated as if that deduction was a recovery deduction under section 168.

(3) Recordkeeping requirement. A taxpayer must be able to substantiate the use of any listed property, as prescribed in section 274(d)(4) and § 1.274–5T or § 1.274–6T, for any taxable year for which recapture under section 280F(b)(3) and paragraph (d) (1) and (2) of this section may occur even if the taxpayer has fully depreciated (or expensed) the listed property in a prior year. For example, in the case of 3-year recovery property, the taxpayer shall maintain a log, journal, etc. for six years even though the taxpayer fully
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If the recovery year is—

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(ii) For 18-year real property: [Reserved]

(iii) For low-income housing: [Reserved]

(f) Examples. The provisions of this section may be illustrated by the following examples. For purposes of these examples, assume that all taxpayers use the calendar year and that no short taxable years are involved.

Example 1. On July 1, 1984, B purchases for $50,000 and places in service an item of listed property (other than a passenger automobile) that is 3-year recovery property under section 168. For the first taxable year that the property is in service, B used the property 80 percent in a trade or business, 20 percent for the production of income, and 20 percent for personal purposes. Although B’s total business investment use is greater than 50 percent, the business use percentage for that taxable year is only 40 percent. Under paragraph (b)(1) of this section, no investment tax credit is allowed for the property.

Example 2. (i) On January 1, 1985, C purchases for $40,000 and places in service an item of listed property (other than a passenger automobile) that is 3-year recovery property under section 168. Seventy percent of the use of the property is in C’s trade or business and 30 percent of the use is for personal purposes. C does not elect a reduced investment tax credit under section 48(q)(4).

(ii) In addition, in 1986, only 50 percent of the use of the property is in C’s trade or business decreased below 70 percent. As a result, a portion of the investment tax credit must be recaptured as an increase in tax liability for 1986 under the rules of section 47 (relating to the recapture of investment tax credit). See section 47(a)(5) and 1.47–2(e) for rules relating to the computation of the recapture amount.
Example 3. On July 1, 1984, B purchases and places in service an item of listed property (other than a passenger automobile) that is 3-year recovery property. B elects to take a reduced investment tax credit under section 48(q)(4). In 1984, B uses the property exclusively in his business. Assume that B’s 1984 allowable recovery deduction is $12,500. In 1985 and 1986, the property is not predominantly used in a qualified business use. The investment tax credit claimed is subject to recapture in full under section 47 in 1985 since the property ceases to be section 38 property in its entirety on January 1, 1985. Under paragraph (c)(2) of this section, B must treat the property for 1985 and subsequent taxable years as if he recovered its cost over a 5-year recovery period (i.e., its earnings and profits life) using the straight line method (with the half-year convention) from the time it was placed in service. Therefore, taxable year 1985 is treated as the property’s second recovery year (of its 5-year recovery period) and the applicable recovery deduction using the straight line method must be used to determine the recovery deduction. Under paragraph (d) of this section, B must recapture any excess depreciation claimed for taxable year 1984. If B had used the straight line method over a 5-year recovery period for 1984 would have been $5,000. Under paragraph (d)(2) of this section, B’s excess depreciation is $7,500 (i.e., $12,500 – $5,000) and that amount must be included in B’s 1985 gross income and added to the property’s basis. The taxable years 1986 through 1989 are the property’s second through sixth recovery years, respectively, of such property’s 5-year recovery period.

Example 4. Assume the same facts as in Example 3, except that in 1986 B used the property exclusively in his business. B is entitled to no investment tax credit with respect to the property in 1986 and must continue to recover the property’s cost over a 5-year recovery period using the straight line method.

Example 5. On July 1, 1984, H purchases and places in service listed property (other than a passenger automobile) which is 3-year recovery property under section 168. H selects the use of the accelerated recovery percentages under section 168(b)(1). H’s recovery deduction for 1984 is $10,550 (i.e., $70,000 reduced by $5,000 section 179 expense). H elects under section 179 to expense $5,000 of the cost of the property. Therefore, taxable year 1985 is treated as the fourth recovery year. Under paragraph (d) of this section, H must recapture any excess depreciation claimed for taxable years 1984 through 1986. H is entitled to no cost recovery deduction under the 5-year straight line method for 1987. Assume further that in 1987 H’s business use percentage for that year is 60 percent. Under paragraph (c)(2) of this section, H must compute his 1986 cost recovery deduction using the straight line method over a 5-year recovery period with 1986 treated as the fifth recovery year.

Example 6. Assume the same facts as in Example 5, except that H uses the property exclusively for personal purposes in 1987. Under paragraph (d) of this section, H must recapture any excess depreciation claimed for taxable years 1984 through 1986. H is entitled to no cost recovery deduction under the 5-year straight line method for 1987. Assume further that in 1987 H’s business use percentage for that year is 70 percent. Under paragraph (c)(2) of this section, H must compute his 1986 cost recovery deduction using the straight line method over a 5-year recovery period with 1986 treated as the fifth recovery year.

Example 7. (i) On July 1, 1984, F purchases for $70,000 and places in service listed property (other than a passenger automobile) which is 3-year recovery property under section 168. F’s business use percentage for 1984 through 1986 is 60 percent. F elects under section 179 to expense $5,000 of the cost of the property. (ii) F selects a reduced investment tax credit under section 48(q)(4). The maximum amount of F’s investment tax credit is $1,560 (i.e., $65,000×.04×.60). (iii) F’s unadjusted basis for purposes of section 168 is $65,000 (i.e., $70,000 reduced by the $5,000 section 179 expense). F selects the use of the accelerated recovery percentages under section 168(b)(1). F’s recovery deduction for 1984 is $9,750 (i.e., $65,000×.25×.60). (iv) In 1985, the property is not predominantly used in a qualified business use. The investment tax credit claimed is subject to recapture in full under section 47 in 1985 since the property ceases to be section 38 property in its entirety on January 1, 1985. Under paragraph (c)(2) of this section, F must treat the property for 1985 and subsequent taxable years as if he recovered its cost over a 5-year recovery period (i.e., its earnings and profits life) using the straight line method (with the half-year convention) from the time it was placed in service. Under paragraph (d) of this section, F must recapture any excess depreciation claimed for taxable year 1984. F’s excess depreciation is $10,050 (i.e., ($65,000×.25×.60+$5,000) – ($70,000×.60×.04)). This amount must be included in F’s 1985 gross income and added to the property’s adjusted basis.

Example 8. (i) On July 1, 1984, G purchases for $60,000 and places in service a passenger automobile which is 3-year recovery property under section 168. (ii) In 1984, G’s business use percentage is 80 percent and such use constitutes his total business/investment use. G elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the basis adjustment under section 48(q)(1). The maximum amount of G’s investment tax credit is $303.33 (i.e., the lesser of .80×.04×$60,000 or $60,000×.04).
§ 1.280F–4T Special rules for listed property (temporary).

(a) Limitations on allowable recovery deductions in subsequent taxable years—
(1) Subsequent taxable years affected by reason of personal use in prior years. For purposes of computing the amount of the recovery deduction for "listed property" for a subsequent taxable year, the amount that would have been allowable as a recovery deduction during an earlier taxable year if all of the use of the property was use described in section 168(c) is treated as the amount of the recovery deduction allowable during that earlier taxable year. The preceding sentence applies with respect to all earlier taxable years, beginning with the first taxable year in which some or all use of the "listed property" is use described in section 168(c). For example, on July 1, 1984, B purchases and places in service listed property (other than a passenger automobile) which is 5-year recovery property under section 168. B selects the use of the accelerated percentages under section 168. B’s business/investment use of the property (all of which is qualified business use as defined in section 280F(d)(6)(B) and §1.280F–4T(a) to account for the amount that would have been allowable in 1990 for 100 percent business/investment use during that year). The maximum amount of G’s 1991 recovery deduction is $3,300 (i.e., .55×$6,000) and his unrecovered basis as of the beginning of 1992 is $14,000 (i.e., $20,000–$6,000). In 1992, G disposes of the automobile. G is not allowed a recovery deduction for 1992.

(ii) In 1984, G does not elect under section 179 to expense a portion of the automobile’s cost. G selects the use of the accelerated recovery percentages under section 168. G’s unrecovered basis as of the beginning of 1984 is $60,000. The maximum amount of G’s 1984 recovery deduction is $3,200 (i.e., the lesser of .80×$4,000 or .80×$60,000).

(iii) In 1985, G’s business use percentage is 55 percent and such use constitutes his total business/investment use. The maximum amount of G’s 1985 recovery deduction is $3,300 (i.e., .55×$6,000 or .55×$38×$60,000).

(iv) In 1985, G’s business use percentage is 45 percent and such use constitutes his total business/investment use. Under paragraph (b)(2) of this section, as a result of the decline in the business use percentage to 50 percent or less, the automobile ceases to be section 38 property in its entirety and G must recapture (pursuant to §§1.47–1(c) and 1.47–2(e)) the investment tax credit previously claimed. Since G’s business use percentage in 1986 is not greater than 50 percent, under the provisions of paragraph (d) of this section, G must recompute (for recapture purposes) his recovery deductions for 1984 and 1985 using the straight line method over a 5-year recovery period (i.e., earnings and profits life for 5-year recovery property using the half-year convention) to determine if any excess depreciation must be included in his 1986 taxable income. G’s recomputed recovery deductions for 1984 and 1985 are $3,200 (i.e., the lesser of .80×$4,000 or .80×$10×$60,000), and $4,800 (i.e., the lesser of .80×$6,000 or .80×$20×$60,000), respectively. G does not have to recapture any excess depreciation since his recovery deductions for 1984 and 1985 computed using the straight line method over a 5-year recovery period are the same as the amounts actually claimed during those years.

(vi) Under paragraph (c)(2) of this section, for 1986 and succeeding taxable years G must compute his remaining recovery deductions using the straight line method over a 5-year recovery period beginning with the third recovery year. The maximum amount of G’s 1986 recovery deduction is $2,700 (i.e., the lesser of .45×$6,000 or .45×$20×$60,000). For taxable years 1987 through 1993, G’s business use percentage is 55 percent and such use constitutes his total business/investment use. G’s 1987 and 1988 recovery deductions are $3,300 per year (i.e., the lesser of .55×$6,000 or .55×$20×$60,000). For taxable year 1989 (the last recovery year), G’s recovery deduction is $3,300 (i.e., .55×$10×$60,000 or .55×$6,000).

(vii) As of the beginning of 1990, G will have claimed a total of $30,600 of recovery deductions. Under §1.280F–2T(c), G may expense his remaining unrecovered basis (up to a certain amount per year) in the first succeeding taxable year after the end of the recovery period and in taxable years thereafter. If G had used his automobile for 100 percent business use in taxable years 1984 through 1989, G could have claimed a recovery deduction of $4,000 in 1984 and a recovery deduction of $6,000 in each of those remaining years. At the beginning of 1990, therefore, G’s unrecovered basis (as defined in section 280F(d)(6)(B)) is $26,000 (i.e., $60,000–$34,000). The maximum amount of G’s 1990 recovery deduction is $3,300 (i.e., .55×$6,000). At the beginning of 1991, G’s unrecovered basis is $20,000 (i.e., $36,000), and his unrecovered basis as of the beginning of 1992 is $14,000 (i.e., $20,000–$6,000). In 1992, G disposes of the automobile. G is not allowed a recovery deduction for 1992.
6(d)(2)) in 1984 through 1988 is 80 percent, 70 percent, 60 percent, and 55 percent, respectively, and B claims recovery deductions for those years based on those percentages. B’s qualified business use for the property for 1989 and taxable years thereafter increases to 100 percent. Pursuant to this rule, B may not claim a recovery deduction in 1989 (or for any subsequent taxable year) for the increase in business use because there is no adjusted basis remaining to be recovered for cost recovery purposes after 1988.

(2) Special rule for passenger automobiles. In the case of a passenger automobile that is subject to the limitations of § 1.280F–2T, the amount treated as the amount that would have been allowable as a recovery deduction if all of the use of the automobile was use described in section 168(c) shall not exceed $4,000 for the year the passenger automobile is placed in service and $6,000 for each succeeding taxable year (adjusted to account for the automobile price inflation adjustment, if any, under section 280F(d)(7) and for short taxable year under § 1.280F–2T(i)(2)). See § 1.280F–3T(g). Example 8.

(b) Treatment of improvements that qualify as capital expenditures—(1) In general. In the case of any improvement that qualifies as a capital expenditure under section 263 made to any listed property other than a passenger automobile, the rules of this paragraph (b) apply. See § 1.280F–2T(f) for the treatment of an improvement made to a passenger automobile.

(2) Investment tax credit allowed for the improvement. If the improvement qualifies as an investment in new section 38 property under section 48(b) and §1.48–2(b), the investment tax credit for that improvement is limited by paragraph (b)(1) of §1.280F–3T, as applied to the item of listed property as a whole.

(3) Cost recovery of the improvement. The improvement is treated as a new item of recovery property. The method of cost recovery with respect to that improvement is limited by §1.280F–3T(c), as applied to the item of listed property as a whole.


§ 1.280F–5T Leased property (temporary).

(a) In general. Except as otherwise provided in this section, the limitations on cost recovery deductions and the investment tax credit provided in section 280F (a) and (b) and §§1.280F–2T and 1.280F–3T do not apply to any listed property leased or held for leasing by any person regularly engaged in the business of leasing listed property. If a person is not regularly engaged in the business of leasing listed property, the limitations on cost recovery deductions and the investment tax credit provided in section 280F and §§1.280F–2T and 1.280F–3T apply to such property leased or held for leasing by such person. The special rules for lessees set out in this section apply with respect to all lessees of listed property, even those whose lessors are not regularly engaged in the business of leasing listed property. For rules on determining inclusion amounts with respect to passenger automobiles, see paragraphs (d), (e) and (g) of this section, and see § 1.280F–7(a). For rules on determining inclusion amounts with respect to other listed property, see paragraphs (f) and (g) of this section, and see § 1.280F–7(b).

(b) Section 48(d) election. If a lessor elects under section 48(d) with respect to any listed property to treat the lessee as having acquired such property, the amount of the investment tax credit allowed to the lessee is subject to the limitation prescribed in §1.280F–3T(b)(1) and (2). If a lessor elects under section 48(d) with respect to any passenger automobile to treat the lessee as having acquired such automobile, the amount of the investment tax credit allowed to the lessee is also subject to the limitations prescribed in §1.280F–2T (a) and (l).

(c) Regularly engaged in the business of leasing. For purposes of paragraph (a)
of this section, a person shall be considered regularly engaged in the business of leasing listed property only if contracts to lease such property are entered into with some frequency over a continuous period of time. The determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the person’s business in its entirety. Occasional or incidental leasing activity is insufficient. For example, a person leasing only one passenger automobile during a taxable year is not regularly engaged in the business of leasing automobiles. In addition, an employer that allows an employee to use the employer’s property for personal purposes and charges such employee for the use of the property is not regularly engaged in the business of leasing with respect to the property used by the employee.

(d) Inclusions in income of lessees of passenger automobiles leased after June 18, 1984, and before April 3, 1985—(1) In general. If a taxpayer leases a passenger automobile after June 18, 1984, but before April 3, 1985, for each taxable year (except the last taxable year) during which the taxpayer leases the automobile, the taxpayer must include in gross income an inclusion amount (pro-rated for the number of days of the lease term included in that taxable year), determined under this paragraph (d)(1), and multiplied by the business/investment use (as defined in §1.280F–6(d)(3)(i)) for the particular taxable year. The inclusion amount:

(i) Is 7.5 percent of the excess (if any) of the automobile’s fair market value over $16,500 for each of the first three taxable years during which a passenger automobile is leased,

(ii) Is 6 percent of the excess (if any) of the automobile’s fair market value over $22,500 for the fourth taxable year during which a passenger automobile is leased,

(iii) Is 6 percent of the excess (if any) of the automobile’s fair market value over $28,500 for the fifth taxable year during which a passenger automobile is leased.

(iv) Is 6 percent of the excess (if any) of the automobile’s fair market value over $34,500 for the sixth taxable year during which a passenger automobile is leased.

For the seventh and subsequent taxable years during which a passenger automobile is leased, the inclusion amount is 6 percent of the excess (if any) of the automobile’s fair market value over the sum of (A) $16,500 and (B) $6,000 multiplied by the number of such taxable years in excess of three years. See paragraph (g)(2) of this section for the definition of fair market value.

(2) Additional inclusion amount when less than predominant use in a qualified business use. (i) If a passenger automobile, which is leased after June 18, 1984, and before April 3, 1985, is not used predominantly in a qualified business use during a taxable year, the lessee must add to gross income in the first taxable year that the automobile is not so used (and only in that year) an inclusion amount determined under this paragraph (d)(2). This inclusion amount is in addition to the amount required to be included in gross income under paragraph (d)(1) of this section.

(ii) If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is greater than $16,500, the inclusion amount is determined by multiplying the average of the business/investment use (as defined in paragraph (h)(3) of this section) by the appropriate dollar amount from the table in paragraph (d)(2)(iii) of this section. If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is $16,500 or less, the inclusion amount is the product of the fair market value of the automobile, the average business/investment use, and the applicable percentage from the table in paragraph (d)(2)(iv) of this section.

(iii) The dollar amount is determined under the following table:
If a passenger automobile is not predominantly used in a qualified business use during—

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(iv) The applicable percentage is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—

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(e) Inclusions in income of lessees of passenger automobiles leased after April 2, 1985, and before January 1, 1987—(1) In general. For any passenger automobile that is leased after April 2, 1985, and before January 1, 1987, for each taxable year (except the last taxable year) during which the taxpayer leases the automobile, the taxpayer must include in gross income an inclusion amount determined under subparagraph (2) through (5) of this paragraph (e). Additional inclusion amounts when a passenger automobile is not used predominantly in a qualified business use during a taxable year are determined under paragraph (e)(6) of this section. See paragraph (h)(2) of this section for the definition of fair market value.

(2) Fair market value not greater than $50,000: years one through three. For any passenger automobile that has a fair market value not greater than $50,000, the inclusion amount for each of the first three taxable years during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the table in paragraph (e)(2)(iv) of this section, select the dollar amount from the column for the quarter of the taxable year in which the automobile is first used under the lease,

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year,

(iii) Multiply the prorated dollar amount by the business/investment use for the taxable year.

(iv) Dollar amounts: Years 1–3:

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§ 1.280F–5T

DOLLAR AMOUNTS: YEARS 1–3—Continued

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<td>48,000</td>
<td>4,843</td>
<td>4,327</td>
<td>4,067</td>
<td>3,695</td>
</tr>
<tr>
<td>48,000</td>
<td>49,000</td>
<td>5,058</td>
<td>4,526</td>
<td>4,267</td>
<td>3,895</td>
</tr>
<tr>
<td>49,000</td>
<td>50,000</td>
<td>5,273</td>
<td>4,926</td>
<td>4,667</td>
<td>4,295</td>
</tr>
</tbody>
</table>

(3) Fair market value not greater than $50,000: years four through six. For any passenger automobile that has a fair market value greater than $18,000, but not greater than $50,000, the inclusion amount for the fourth, fifth, and sixth taxable years during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the table in paragraph (e)(3)(iv) of this section, select the dollar amount from the column for the taxable year in which the automobile is used under the lease,

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(iii) Multiply this dollar amount by the business/investment use for the taxable year.

(iv) Dollar Amounts: Years 4–6:

<table>
<thead>
<tr>
<th>Fair market value</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater than—</td>
<td>But not greater than—</td>
</tr>
<tr>
<td>$18,000</td>
<td>$18,500</td>
</tr>
<tr>
<td>18,500</td>
<td>19,000</td>
</tr>
<tr>
<td>19,000</td>
<td>19,500</td>
</tr>
<tr>
<td>19,500</td>
<td>20,000</td>
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<td>20,000</td>
<td>20,500</td>
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<td>20,500</td>
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<td>21,000</td>
<td>21,500</td>
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<td>21,500</td>
<td>22,000</td>
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<td>22,000</td>
<td>23,000</td>
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<tr>
<td>25,000</td>
<td>26,000</td>
</tr>
<tr>
<td>26,000</td>
<td>27,000</td>
</tr>
<tr>
<td>27,000</td>
<td>28,000</td>
</tr>
<tr>
<td>28,000</td>
<td>29,000</td>
</tr>
</tbody>
</table>

(4) Fair market value greater than $50,000: years one through six. (i) For any passenger automobile that has a fair market value greater than $50,000, the inclusion amount for the first six taxable years during which the automobile is leased is determined as follows:

(A) Determine the dollar amount by using the appropriate formula in paragraph (e)(4)(ii) of this section,

(B) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(C) Multiply this dollar amount by the business/investment use for the taxable year.

(ii) The dollar amount is computed as follows:

(A) If the automobile is first used under the lease in the fourth quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(1) $124, and

(2) 11 percent of the excess of the automobile’s fair market value over $13,200.

(B) If the automobile is first used under the lease in the third quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(1) $110, and
(2) 10 percent of the excess of the automobile’s fair market value over $13,200.

(C) If the automobile is first used under the lease in the second quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(1) $100, and
(2) 9 percent of the excess of the automobile’s fair market value over $13,200.

(D) If the automobile is first used under the lease in the first quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(1) $90, and
(2) 8 percent of the excess of the automobile’s fair market value over $13,200.

(E) For the fourth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile’s fair market value over $18,000.

(F) For the fifth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile’s fair market value over $22,800.

(G) For the sixth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile’s fair market value over $27,600.

(5) Seventh and subsequent taxable years. (i) For any passenger automobile that has a fair market value less than or equal to $32,400, the inclusion amount for the seventh and subsequent taxable years during which the automobile is leased is zero.

(ii) For any passenger automobile that has a fair market value greater than $32,400, the inclusion amount for the seventh and subsequent taxable years during which the automobile is leased is 6 percent of—

(A) The excess (if any) of the automobile’s fair market value, over
(B) The sum of—

(1) $13,200 and
(2) $4,800 multiplied by the number of taxable years in excess of three years.

(6) Additional inclusion amount when less than predominant use in a qualified business use. (i) If a passenger automobile, which is leased after April 2, 1985, and before January 1, 1987, is not predominantly used in a qualified business use during a taxable year, the lessee must add to gross income in the first taxable year that the automobile is not so used (and only in that year) an inclusion amount determined under this paragraph (e)(6). This inclusion amount is in addition to the amount required to be included in gross income under paragraph (e) (2), (3), (4), and (5) of this section.

(ii) If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is greater than $11,250, the inclusion amount is determined by multiplying the average of the business/investment use (as defined in paragraph (h)(3) of this section) by the appropriate dollar amount from the table in paragraph (e)(6)(i) of this section. If the fair market value of the automobile is $11,250 or less, the inclusion amount is the product of the fair market value of the automobile, the average business/investment use, and the applicable percentage from the table in paragraph (e)(6)(iv) of this section.

(iii) The dollar amount is determined under the following table:

<table>
<thead>
<tr>
<th>If a passenger automobile is not predominantly used in a qualified business use during—</th>
<th>The dollar amount is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term (years)</td>
<td>1</td>
</tr>
<tr>
<td>The first taxable year of the lease term</td>
<td>$350</td>
</tr>
<tr>
<td>The second taxable year of the lease term</td>
<td></td>
</tr>
<tr>
<td>The third taxable year of the lease term</td>
<td></td>
</tr>
<tr>
<td>The fourth taxable year of the lease term</td>
<td></td>
</tr>
<tr>
<td>The fifth taxable year of the lease term</td>
<td></td>
</tr>
<tr>
<td>The sixth taxable year of the lease term</td>
<td></td>
</tr>
<tr>
<td>The seventh taxable year of the lease term</td>
<td></td>
</tr>
</tbody>
</table>

(iv) The applicable percentage is determined under the following table:

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4 or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>The first taxable year of the lease term</td>
<td>$350</td>
<td>$700</td>
<td>$1,150</td>
<td>$1,500</td>
</tr>
<tr>
<td>The second taxable year of the lease term</td>
<td></td>
<td>150</td>
<td>700</td>
<td>1,200</td>
</tr>
<tr>
<td>The third taxable year of the lease term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The fourth taxable year of the lease term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The fifth taxable year of the lease term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The sixth taxable year of the lease term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The seventh taxable year of the lease term</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


849
If a passenger automobile is not predominantly used in a qualified business use during—

<table>
<thead>
<tr>
<th>Lease term (years)</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4 or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>The first taxable year of the lease term</td>
<td>3.0</td>
<td>6.0</td>
<td>10.2</td>
<td>13.2</td>
</tr>
<tr>
<td>The second taxable year of the lease term</td>
<td>1.25</td>
<td>6.2</td>
<td>10.4</td>
<td></td>
</tr>
<tr>
<td>The third taxable year of the lease term</td>
<td></td>
<td>2.25</td>
<td>6.5</td>
<td></td>
</tr>
<tr>
<td>The fourth taxable year of the lease term</td>
<td></td>
<td></td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>The fifth taxable year of the lease term</td>
<td></td>
<td></td>
<td>0.5</td>
<td></td>
</tr>
</tbody>
</table>

(f) Inclusions in income of lessees of listed property other than passenger automobiles—(1) In general. If listed property other than a passenger automobile is not used predominantly in a qualified business use in any taxable year in which such property is leased, the lessee must add an inclusion amount to gross income in the first taxable year in which such property is not so predominantly used (and only in that year). This inclusion amount is determined under paragraph (f)(2) of this section for property leased after June 18, 1984, and before January 1, 1987. The inclusion amount is determined under §1.280F–7(b) for property leased after December 31, 1986.

(2) Inclusion amount for property leased after June 18, 1984, and before January 1, 1987. The inclusion amount for property leased after June 18, 1984, and before January 1, 1987, is the product of the following amounts:

(i) The fair market value (as defined in paragraph (h)(2) of this section) of the property.

(ii) The average business/investment use (as defined in paragraph (h)(3) of this section), and

(iii) The applicable percentage (as determined under paragraph (f)(3) of this section).

(3) Applicable percentages. The applicable percentages for 3-, 5-, and 10-year recovery property are determined according to the following tables:

(i) In the case of 3-year recovery property:

<table>
<thead>
<tr>
<th>Taxable year during lease term</th>
<th>For the first taxable year in which the business use percentage is 50 percent or less, the applicable percentage for such taxable year is—</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>For a lease term of:</td>
<td></td>
</tr>
<tr>
<td>1 year</td>
<td></td>
</tr>
<tr>
<td>2 years</td>
<td></td>
</tr>
<tr>
<td>3 years</td>
<td></td>
</tr>
<tr>
<td>4 or more years</td>
<td></td>
</tr>
</tbody>
</table>

(ii) In the case of 5-year recovery property:

<table>
<thead>
<tr>
<th>Taxable year during lease term</th>
<th>For the first taxable year in which the business use percentage is 50 percent or less, the applicable percentage for such taxable year is—</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>For a lease term of:</td>
<td></td>
</tr>
<tr>
<td>1 year</td>
<td></td>
</tr>
<tr>
<td>2 years</td>
<td></td>
</tr>
<tr>
<td>3 years</td>
<td></td>
</tr>
<tr>
<td>4 years</td>
<td></td>
</tr>
<tr>
<td>5 years</td>
<td></td>
</tr>
<tr>
<td>6 or more years</td>
<td></td>
</tr>
</tbody>
</table>

(iii) In the case of 10-year recovery property:
(g) Special rules applicable to inclusions in income of lessees. This paragraph (g) applies to the inclusions in gross income of lessees prescribed under paragraphs (d)(2), (e)(6), or (f) of this section, or prescribed under §1.280F–7(b).

(1) Lease term commences within 9 months of the end of lessee’s taxable year. If:

(i) The lease term commences within 9 months before the close of the lessee’s taxable year;

(ii) The property is not predominantly used in a qualified business use during that portion of the taxable year, and

(iii) The lease term continues into the lessee’s subsequent taxable year, then the inclusion amount is added to gross income in the lessee’s subsequent taxable year and the amount is determined by taking into account the average of the business/investment use for both taxable years and the applicable percentage for the taxable year in which the lease term begins (or, in the case of a passenger automobile with a fair market value greater than $16,500, the appropriate dollar amount for the taxable year in which the lease term begins).

(2) Lease term less than one year. If the lease term is less than one year, the amount which must be added to gross income is an amount that bears the same ratio to the inclusion amount determined before the application of this paragraph (g)(2) as the number of days in the lease term bears to 365.

(3) Maximum inclusion amount. The inclusion amount shall not exceed the sum of all deductible amounts in connection with the use of the listed property properly allocable to the lessee’s taxable year in which the inclusion amount must be added to gross income.

(h) Definitions—(1) Lease term. In determining the term of any lease for purposes of this section, the rules of section 168(i)(3)(A) shall apply.

(2) Fair market value. For purposes of this section, the fair market value of listed property is such value on the first day of the lease term. If the capitalized cost of listed property is specified in the lease agreement, the lessee shall treat such amount as the fair market value of the property.

(3) Average business/investment use. For purposes of this section, the average business/investment use of any listed property is the average of the business/investment use for the first taxable year in which the lease term begins and all preceding taxable years in which such property is leased. See paragraph (g)(1) of this section for special rule when lease term commences within 9 months before the end of the lessee’s taxable year.

(1) Examples. This section may be illustrated by the following examples.

Example 1. On January 1, 1985, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $55,000. The lease is to be for a period of four years. During taxable years 1985

<table>
<thead>
<tr>
<th>Taxable year during lease term</th>
<th>For the first taxable year in which the business use percentage is 50 per cent or less, the applicable percentage for such taxable year is—</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>For a lease term of:</td>
<td></td>
</tr>
<tr>
<td>1 year</td>
<td>2.5</td>
</tr>
<tr>
<td>2 years</td>
<td>5.1</td>
</tr>
<tr>
<td>3 years</td>
<td>9.8</td>
</tr>
<tr>
<td>4 years</td>
<td>14.0</td>
</tr>
<tr>
<td>5 years</td>
<td>17.8</td>
</tr>
<tr>
<td>6 years</td>
<td>21.3</td>
</tr>
<tr>
<td>7 years</td>
<td>21.9</td>
</tr>
<tr>
<td>8 years</td>
<td>22.4</td>
</tr>
<tr>
<td>9 years</td>
<td>22.9</td>
</tr>
<tr>
<td>10 years</td>
<td>23.5</td>
</tr>
<tr>
<td>11 years</td>
<td>23.9</td>
</tr>
<tr>
<td>12 years</td>
<td>24.3</td>
</tr>
<tr>
<td>13 years</td>
<td>24.7</td>
</tr>
<tr>
<td>14 years</td>
<td>25.0</td>
</tr>
<tr>
<td>15 or more years</td>
<td>25.3</td>
</tr>
</tbody>
</table>
§ 1.280F-6

and 1986, A uses the automobile exclusively in a trade or business. Under paragraph (d)(1) of this section, A must include in gross income in both 1985 and 1986, $2,687.50 (i.e., ($50,000 - $16,500) × 7.5%).

Example 2. The facts are the same as in Example 1, and in addition, A uses the automobile only 45 percent in a trade or business during 1987. Under paragraph (d)(1) of this section for 1987, A must include in gross income $1,299.38 (i.e., ($50,000 - $16,500) × 0.5 × 0.45%). In addition, under paragraph (d)(2) of this section, A must also include in gross income in 1987, $350.85 (i.e., $650 × 0.57%), average business/investment use).

Example 3. On August 1, 1985, B, a calendar year taxpayer, leases and places in service an item of listed property which is 5-year recovery property, with a fair market value of $10,000. The lease is to be for a period of 5 years. B’s qualified business use of the property is 40 percent in 1985, 100 percent in 1986, and 90 percent in 1987. Under paragraphs (f)(1) and (g)(1) of this section, before the application of paragraph (g)(3) of this section, B must include in gross income in 1986, $1,298.60 (i.e., $10,000 × 0.70% × 18.4%), the product of the fair market value, the average business use for both taxable years, and the applicable percentage for year one from the table in paragraph (f)(3)(iii) of this section.

Example 4. On October 1, 1985, C, a calendar year taxpayer, leases and places in service an item of listed property which is 3-year recovery property with a fair market value of $15,000. The lease term is 6 months (ending March 31, 1986) during which C uses the property 45 percent in the trade or business, the only business/investment use. Under paragraphs (f)(1) and (g)(1) and (2) of this section, before the application of paragraph (g)(3) of this section, C must include in gross income in 1986, $1,000.97 (i.e., $15,000 × 0.45% × 70% × 182/365), the product of the fair market value, the average business use for both taxable years, and the applicable percentage for year one from the table in paragraph (f)(3)(i) of this section, prorated for the length of the lease term.

Example 5. On July 15, 1985, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $15,000. The lease is for a period of 5 years, during which A uses the automobile exclusively in a trade or business. Under paragraph (e)(2) and (3) of this section, for taxable years 1985 through 1989, A must include the following amounts in gross income:

<table>
<thead>
<tr>
<th>Taxable year</th>
<th>Dollar amount</th>
<th>Prorata</th>
<th>Business use (per cent)</th>
<th>Inclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$3,327</td>
<td>170/365</td>
<td>100</td>
<td>$1,550</td>
</tr>
<tr>
<td>1986</td>
<td>$3,327</td>
<td>365/365</td>
<td>100</td>
<td>3,327</td>
</tr>
<tr>
<td>1987</td>
<td>$3,327</td>
<td>365/365</td>
<td>100</td>
<td>3,327</td>
</tr>
</tbody>
</table>

Example 6. The facts are the same as in Example 1, except that A uses the automobile only 45 percent in a trade or business during 1987 through 1990. Under §1.280F-5T(e)(6), A must include in gross income for taxable year 1987, the first taxable year in which the automobile is not used predominantly in a trade or business, an additional amount based on the average business/investment use for taxable years 1985 through 1987. For taxable years 1985 through 1989, A must include the following amounts in gross income:

<table>
<thead>
<tr>
<th>Taxable year</th>
<th>Dollar amount</th>
<th>Prorata</th>
<th>Business use (per cent)</th>
<th>Inclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$3,327</td>
<td>170/365</td>
<td>100</td>
<td>$1,550</td>
</tr>
<tr>
<td>1986</td>
<td>$3,327</td>
<td>365/365</td>
<td>100</td>
<td>3,327</td>
</tr>
<tr>
<td>1987</td>
<td>$3,327</td>
<td>365/365</td>
<td>45</td>
<td>1,497</td>
</tr>
<tr>
<td>1988</td>
<td>$1,650</td>
<td>366/366</td>
<td>45</td>
<td>743</td>
</tr>
<tr>
<td>1989</td>
<td>$1,362</td>
<td>365/365</td>
<td>45</td>
<td>613</td>
</tr>
</tbody>
</table>


§ 1.280F-6 Special rules and definitions.

(a) Deductions of employee—(1) In general. Employee use of listed property shall not be treated as business/investment use (as defined in paragraph (d)(3) of this section) for purposes of determining the amount of any recovery deduction allowable (including any deduction under section 179) to the employee unless that use is for the convenience of the employer and required as a condition of employment.

(2) “Convenience of the employer” and “condition of employment” requirements—(1) In general. The terms convenience of the employer and condition of employment generally have the same meaning for purposes of section 280F as they have for purposes of section 119 (relating to the exclusion from gross income for meals or lodging furnished for the convenience of the employer).
(i) "Condition of employment." In order to satisfy the "condition of employment" requirement, the use of the property must be required in order for the employee to perform the duties of his or her employment properly. Whether the use of the property is so required depends on all the facts and circumstances. Thus, the employer need not explicitly require the employee to use the property. Similarly, a mere statement by the employer that the use of the property is a condition of employment is not sufficient.

(ii) "Convenience of employer". [Reserved]

(3) Employee use. For purposes of this section, the term employee use means any use in connection with the performance of services by the employee as an employee.

(4) Examples. The principles of this paragraph are illustrated in the following examples:

Example 1. A is employed as a courier with W, which provides local courier services. A owns and uses a motorcycle to deliver packages to downtown offices for W. W does not provide delivery vehicles and explicitly requires all of its couriers to own a car or motorcycle for use in their employment with the company. A’s use of the motorcycle for delivery purposes is for the convenience of W and is required as a condition of employment.

Example 2. B is an inspector for X, a construction company with many construction sites in the local area. B is required to travel to the various construction sites on a regular basis; B uses her automobile to make these trips. Although X does not furnish B an automobile, X does not explicitly require B to use her own automobile. However, X reimburses B for any costs she incurs in traveling to the various job sites. B’s use of her automobile in her employment is for the convenience of X and is required as a condition of employment.

Example 3. Assume the same facts as in Example 2, except that X makes an automobile available to B who chooses to use her own automobile and receive reimbursement. B’s use of her own automobile is not for the convenience of X and is not required as a condition of employment.

Example 4. C is a pilot for Y, a small charter airline. Y requires its pilots to obtain x hours of flight time annually in addition to the number of hours of flight time spent with the airline. Pilots can usually obtain these hours by flying with a military reserve unit or by flying part-time with another airline. C owns his own airplane. C’s use of his airplane to obtain the required flight hours is not for the convenience of the employer and is not required as a condition of employment.

Example 5. D is employed as an engineer with Z, an engineering contracting firm. D occasionally takes work home at night rather than working late in the office. D owns and uses a computer which is virtually identical to the one she uses at the office to complete her work at home. D’s use of the computer is not for the convenience of her employer and is not required as a condition of employment.

(b) Listed property—(1) In general. Except as otherwise provided in paragraph (b)(5) of this section, the term listed property means:

(i) Any passenger automobile (as defined in paragraph (c) of this section), (ii) Any other property used as a means of transportation (as defined in paragraph (b)(2) of this section), (iii) Any property of a type generally used for purposes of entertainment, recreation, or amusement, and (iv) Any computer or peripheral equipment (as defined in section 168(1)(2)(B)), and (v) Any other property specified in paragraph (b)(4) of this section.

(2) Means of transportation—(1) In general. Except as otherwise provided in paragraph (b)(2)(i) of this section, property used as a means of transportation includes trucks, buses, trains, boats, airplanes, motorcycles, and any other vehicles for transporting persons or goods.

(i) Exception. The term "listed property" does not include any vehicle that is a qualified nonpersonal use vehicle as defined in section 274(i) and §1.274-5(k).

(3) Property used for entertainment, etc.—(i) In general. Property of a type generally used for purposes of entertainment, recreation, or amusement includes property such as photographic, phonographic, communication, and video recording equipment.

(ii) Exception. The term listed property does not include any photographic, phonographic, communication, or video recording equipment of a taxpayer if the equipment is use either exclusively at the taxpayer’s regular business establishment or in connection with the taxpayer’s principal trade or business.
(iii) Regular business establishment. The regular business establishment of an employee is the regular business establishment of the employer of the employee. For purposes of this paragraph (b)(3), a portion of a dwelling unit is treated as a regular business establishment if the requirements of section 280A(c)(1) are met with respect to that portion.

(4) Other property. [Reserved]

(5) Exception for computers. The term listed property shall not include any computer (including peripheral equipment) used exclusively at a regular business establishment. For purposes of the preceding sentence, a portion of a dwelling unit shall be treated as a regular business establishment if (and only if) the requirements of section 280A(c)(1) are met with respect to that portion.

c (Passenger automobile) — (1) In general. Except as provided in paragraph (c)(3) of this section, the term passenger automobile means any 4-wheeled vehicle which is:

(i) Manufactured primarily for use on public streets, roads, and highways, and

(ii) Rated at 6,000 pounds gross vehicle weight or less.

(2) Parts, etc. of automobile. The term passenger automobile includes any part, component, or other item that is physically attached to the automobile or is traditionally included in the purchase price of an automobile. The term does not include repairs that are not capital expenditures within the meaning of section 263.

(3) Exception for certain vehicles. The term passenger automobile shall not include any:

(i) Ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business,

(ii) Vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, or

(iii) Truck or van that is a qualified nonpersonal use vehicle as defined under §1.274–5T(k).

(d) Business use percentage — (1) In general. The term business use percentage means the percentage of the use of any listed property which is qualified business use as described in paragraph (d)(2) of this section.

(2) Qualified business use — (i) In general. Except as provided in paragraph (d)(2)(ii) of this section, the term qualified business use means any use in a trade or business of the taxpayer. The term qualified business use does not include use for which a deduction is allowable under section 212. Whether the amount of qualified business use exceeds 50 percent is determinative of whether the investment tax credit and the accelerated percentages under section 168 are available for listed property (or must be recaptured). See §1.280F–3T.

(ii) Exception for certain use by 5-percent owners and related persons — (A) In general. The term qualified business use shall not include:

(1) Leasing property to any 5-percent owner or related person,

(2) Use of property provided as compensation for the performance of services by a 5-percent owner or related person, or

(3) Use of property provided as compensation for the performance of services by any person not described in paragraph (d)(2)(ii)(A)(2) of this section unless an amount is properly reported by the taxpayer as income to such person and, where required, there was withholding under chapter 24. Paragraph (d)(2)(ii)(A)(1) of this section shall apply only to the extent that the use of the listed property is by an individual who is a related party or a 5-percent owner with respect to the owner or lessee of the property.

(B) Special rule for aircraft. Paragraph (d)(2)(ii)(A) of this section shall not apply with respect to any aircraft if at least 25 percent of the total use of the aircraft during the taxable year consists of qualified business use not described in paragraph (d)(2)(ii)(A).

(C) Definitions. For purposes of this paragraph:

(1) 5-percent owner. The term 5-percent owner means any person who is a 5-percent owner with respect to the taxpayer (as defined in section 416 (i)(1)(B)(i)).

(2) Related person. The term related person means any person related to the taxpayer (within the meaning of section 267(b)).
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(3) Business/investment use.—(i) In general. The term business/investment use means the total business or investment use of listed property that may be taken into account for purposes of computing (without regard to section 280F(b)) the percentage of cost recovery deduction for a passenger automobile or other listed property for the taxable year. Whether the accelerated percentages under section 168 (as opposed to use of the straight line method of cost recovery) are available with respect to listed property or must be recaptured is determined, however, by reference to qualified business use (as defined in paragraph (d)(2) of this section) rather than by reference to business/investment use. Whether a particular use of property is a business or investment use. Whether a particular use of property is a business or investment use shall generally be determined under the rules of section 162 or 212.

(ii) Entertainment use. The use of listed property for entertainment, recreation, or amusement purposes shall be treated as business use to the extent that expenses other than interest and property tax expenses attributable to that use are deductible after application of section 274.

(iii) Employee use. See paragraph (a) of this section for requirements to be satisfied for employee use of listed property to be considered business/investment use of the property.

(iv) Use of taxpayer’s automobile by another person. Any use of the taxpayer’s automobile by another person shall not be treated, for purposes of section 280F, as use in a trade or business under section 162 unless that use:

(A) Is directly connected with the business of the taxpayer,

(B) Is properly reported by the taxpayer as income to the other person and, where required, there was withholding under chapter 24, or

(C) Results in a payment of fair market rent.

For purposes of this paragraph (d)(4)(iv)(C), payment to the owner of the automobile in connection with such use is treated as the payment of rent.

(4) Predominantly used in qualified business use.—(1) Definition. Property is predominantly used in a qualified business use for any taxable year if the business use percentage (as defined in paragraph (d)(1) of this section) is greater than 50 percent.

(ii) Special rule for transfers at death. Property does not cease to be used predominantly in a qualified business use by reason of a transfer at death.

(iii) Other dispositions of property. [Reserved]

(5) Examples. The following examples illustrate the principles set forth in this paragraph.

Example 1. E uses a home computer 50 percent of the time to manage her investments. The computer is listed property within the meaning of section 280F(d)(4). E also uses the computer 40 percent of the time in her part-time consumer research business. Because E’s business use percentage for the computer does not exceed 50 percent, the computer is not predominantly used in a qualified business use for the taxable year. Her aggregate business/investment use for purposes of determining the percent of the total allowable straight line depreciation that she can claim is 90 percent.

Example 2. Assume that E in Example 1 uses the computer 30 percent of the time to manage her investments and 60 percent of the time in her consumer research business. E’s business use percentage exceeds 50 percent. Her aggregate business/investment use for purposes of determining her allowable investment tax credit and cost recovery deductions is 90 percent.

Example 3. F is the proprietor of a plumbing contracting business. F’s brother is employed with F’s company. As part of his compensation, F’s brother is allowed to use one of the company automobiles for personal use. The use of the company automobiles by F’s brother is not a qualified business use because F and F’s brother are related parties within the meaning of section 267(b).

Example 4. F, in Example 3, allows employees unrelated to him to use company automobiles as part of their compensation. F, however, does not include the value of these automobiles in the employees’ gross income and F does not withhold with respect to the use of these automobiles. The use of the company automobiles by the employees in this case is not business/investment use.

Example 5. X Corporation owns several automobiles which its employees use for business purposes. The employees are also allowed to take the automobiles home at night. However, the fair market value of the use of the automobile for any personal purpose, e.g., commuting to work, is reported by X as income to the employee and is withheld upon by X. The use of the automobile by the employee, even for personal purposes, is a qualified business use the respect to X.
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(e) Method of allocating use of property—(1) In general. For purposes of section 280F, the taxpayer shall allocate the use of any listed property that is used for more than one purpose during the taxable year to the various uses in the manner prescribed in paragraph (e) (2) and (3) of this section.

(2) Passenger automobiles and other means of transportation. In the case of a passenger automobile or any other means of transportation, the taxpayer shall allocate the use of the property on the basis of mileage. Thus, the percentage of use in a trade or business for the year shall be determined by dividing the number of miles the vehicle is driven for purposes of that trade or business during the year by the total number of miles the vehicle is driven during the year for any purpose.

(3) Other listed property. In the case of other listed property, the taxpayer shall allocate the use of that property on the basis of the most appropriate unit of time the property is actually used (rather than merely being available for use). For example, the percentage of use of a computer in a trade or business for a taxable year is determined by dividing the number of hours the computer is used during the year by the total number of hours the computer is used for any purpose during the year.

(f) Effective date—(1) In general. Except as provided in paragraph (f)(2) of this section, this section applies to property placed in service by a taxpayer on or after July 7, 2003. For regulations applicable to property placed in service before July 7, 2003, see §1.280F–6T as in effect prior to July 7, 2003 (§1.280F–6T as contained in 26 CFR part 1, revised as of April 1, 2003).

(2) Property placed in service before July 7, 2003. The following rules apply to property that is described in paragraph (c)(3)(iii) of this section, was placed in service by the taxpayer before July 7, 2003, and was treated by the taxpayer as a passenger automobile under §1.280F–6T as in effect prior to July 7, 2003 (pre-effective date vehicle):

(i) Except as provided in paragraphs (f)(2)(ii), (iii), and (iv) of this section, a pre-effective date vehicle will be treated as a passenger automobile to which section 280F(a) applies.

(ii) A pre-effective date vehicle will be treated as property to which section 280F(a) does not apply if the taxpayer adopts that treatment in determining depreciation deductions on the taxpayer’s original return for the year in which the vehicle is placed in service.

(iii) A pre-effective date vehicle will be treated, to the extent provided in this paragraph (f)(2)(iii), as property to which section 280F(a) does not apply if the taxpayer adopts that treatment on an amended Federal tax return in accordance with this paragraph (f)(2)(iii). This paragraph (f)(2)(iii) applies only if, on or before December 31, 2004, the taxpayer files, for all applicable taxable years, amended Federal tax returns (or qualified amended returns, if applicable (for further guidance, see Rev. Proc. 94–69 (1994–2 C.B. 804) and §601.601(d)(2)(i)(b) of this chapter)) treating the vehicle as property to which section 280F(a) does not apply.

The applicable taxable years for this purpose are the taxable year in which the vehicle was placed in service by the taxpayer (or, if the period of limitation for assessment under section 6501 has expired for such year or any subsequent year (a closed year), the first taxable year following the most recent closed year) and all subsequent taxable years in which the vehicle was treated on the taxpayer’s return as property to which section 280F(a) applies. If the earliest applicable taxable year is not the year in which the vehicle was placed in service, the adjusted depreciable basis of the property as of the beginning of the first applicable taxable year is recovered over the remaining recovery period. If the remaining recovery period as of the beginning of the first applicable taxable year is less than 12 months, the entire adjusted depreciable basis of the property as of the beginning of the first applicable taxable year is recovered in that year.

(iv) A pre-effective date vehicle will be treated, to the extent provided in this paragraph (f)(2)(iv), as property to which section 280F(a) does not apply if the taxpayer adopts that treatment on Form 3115, Application for Change in Accounting Method, in accordance with this paragraph (f)(2)(iv). The taxpayer must follow the applicable administrative procedures issued under

(a) Inclusions in income of lessees of passenger automobiles leased after December 31, 1986—(1) In general. If a taxpayer leases a passenger automobile after December 31, 1986, the taxpayer must include in gross income an inclusion amount determined under this paragraph (a), for each taxable year during which the taxpayer leases the automobile. This paragraph (a) applies only to passenger automobiles for which the taxpayer’s lease term begins after December 31, 1986. See §§ 1.280F–5T(d) and 1.280F–5T(e) for rules on determining inclusion amounts for passenger automobiles for which the taxpayer’s lease term begins before January 1, 1987. See § 1.280F–5T(h)(2) for the definition of fair market value.

(2) Inclusion Amount. For any passenger automobile leased after December 31, 1986, the inclusion amount for each taxable year during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the applicable table, select the dollar amount from the column for the taxable year in which the automobile is used under the lease (but for the last taxable year during any lease that does not begin and end in the same taxable year, use the dollar amount for the preceding taxable year).

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year.

(iii) Multiply the prorated dollar amount by the business/investment use (as defined in § 1.280F–6(d)(3)(i)) for the taxable year.

(iv) The following table is the applicable table in the case of a passenger automobile leased after December 31, 1986, and before January 1, 1989:

**Dollar Amounts for Automobiles With a Lease Term Beginning in Calendar Year 1987 or 1988**

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<tr>
<td>47,500</td>
<td>982</td>
<td>1,932</td>
<td>3,098</td>
<td>3,279</td>
<td>4,236</td>
</tr>
</tbody>
</table>
(v) The applicable table in the case of a passenger automobile first leased after December 31, 1988, will be contained in a revenue ruling or revenue procedure published in the Internal Revenue Bulletin.

(3) Example. The following example illustrates the application of this paragraph (a):

Example. On April 1, 1987, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $31,500. The lease is to be for a period of three years. During taxable years 1987 and 1988, A uses the automobile exclusively in a trade or business. During 1989 and 1990, A’s business/investment use is 45 percent. The appropriate dollar amounts from the table in paragraph (a)(2)(iv) of this section are $260 for 1987 (first taxable year during the lease), $568 for 1988 (second taxable year during the lease), $842 for 1989 (third taxable year during the lease), and $842 for 1990. Since 1990 is the last taxable year during the lease, the dollar amount for the preceding year (the third year) is used, rather than the dollar amount for the fourth year. For taxable years 1987 through 1990, A’s inclusion amounts are determined as follows:

<table>
<thead>
<tr>
<th>Tax year</th>
<th>Dollar amount</th>
<th>Proration</th>
<th>Business use (percent)</th>
<th>Inclusion amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$260</td>
<td>275/365</td>
<td>100</td>
<td>$196</td>
</tr>
<tr>
<td>1988</td>
<td>568</td>
<td>366/366</td>
<td>100</td>
<td>568</td>
</tr>
<tr>
<td>1989</td>
<td>842</td>
<td>365/365</td>
<td>45</td>
<td>379</td>
</tr>
<tr>
<td>1990</td>
<td>842</td>
<td>90/365</td>
<td>45</td>
<td>93</td>
</tr>
</tbody>
</table>

(b) Inclusions in income of lessees of listed property (other than passenger automobiles) leased after December 31, 1986

(1) In general. If listed property other than a passenger automobile is not used predominantly in a qualified business use in any taxable year in which such property is leased, the lessee must add an inclusion amount to gross income in the first taxable year in which such property is not so predominantly used (and only in that year). This year is the first taxable year in which the business use percentage (as defined in §1.280F–6(d)(1)) is 50 percent or less. This inclusion amount is determined under this paragraph (b) for property for which the taxpayer’s lease term begins after December 31, 1986 (and under §1.280F–5T(f) for property for which the taxpayer’s lease term begins before January 1, 1987). See also §1.280F–5T(g).

(2) Inclusion amount. The inclusion amount for any listed property (other than a passenger automobile) leased after December 31, 1986, is the sum of the amounts determined under subdivisions (i) and (ii) of this subparagraph (2).

(i) The amount determined under this subdivision (i) is the product of the following amounts:

(A) The fair market value (as defined in §1.280F–5T(h)(2)) of the property,
(B) The business/investment use (as defined in §1.280F–6(d)(3)(i)) for the first taxable year in which the business use percentage (as defined in §1.280F–6(d)(1)) is 50 percent or less, and
(C) The applicable percentage from the following table:

<table>
<thead>
<tr>
<th>Type of property</th>
<th>First taxable year during lease in which business use percentage is 50% or less</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Property with a recovery period of less than 7 years under the alternative depreciation system (such as computers, trucks and airplanes)</td>
<td>2.1</td>
</tr>
<tr>
<td>Property with a 7- to 10-year recovery period under the alternative depreciation system (such as recreation property)</td>
<td>3.9</td>
</tr>
<tr>
<td>Property with a recovery period of more than 10 years under the alternative depreciation system (such as certain property with no class life)</td>
<td>6.6</td>
</tr>
</tbody>
</table>

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(ii) The amount determined under this subdivision (ii) is the product of the following amounts:
(A) The fair market value of the property,
(B) The average of the business/investment use for all taxable years (in which such property is leased) that precede the first taxable year in which the business use percentage is 50 percent or less, and
(C) The applicable percentage from the following table:

<table>
<thead>
<tr>
<th>Type of property</th>
<th>First taxable year during lease in which business use percentage is 50% or less</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property with a recovery period of less than 7 years under the alternative depreciation system (such as computers, trucks and airplanes)</td>
<td>0.0 10.0 22.0 21.2 12.7 12.7 12.7 12.7 12.7 12.7 12.7</td>
</tr>
<tr>
<td>Property with a 7- to 10-year recovery period under the alternative depreciation system (such as recreation property)</td>
<td>0.0 9.3 23.8 31.3 33.8 32.7 31.6 30.5 25.0 15.0 15.0 15.0</td>
</tr>
<tr>
<td>Property with a recovery period of more than 10 years under the alternative depreciation system (such as certain property with no class life)</td>
<td>0.0 10.1 26.3 35.4 39.6 40.2 40.8 41.4 37.5 29.2 20.8 12.5</td>
</tr>
</tbody>
</table>

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

Example. On February 1, 1987, B, a calendar year taxpayer, leases and places in service a computer with a fair market value of $3,000. The lease is to be for a period of two years. B's qualified business use of the property, which is the only business/investment use, is 80 percent in taxable year 1987, 40 percent in taxable year 1988, and 35 percent in taxable year 1989. B must add an inclusion amount to gross income for taxable year 1988, the first taxable year in which B does not use the computer predominantly for business (i.e., the first taxable year in which B's business use percentage is 50 percent or less). Since 1988 is the second taxable year during the lease, and since the computer has a 5-year recovery period under the General and Alternative Depreciation Systems, the applicable percentage from the table in subdivision (i) of paragraph (b)(2) is −7.2%, and the applicable percentage from the table in subdivision (ii) is 10%. B's inclusion amount is $154, which is the sum of the amounts determined under subdivisions (i) and (ii) of subparagraph (b)(2) of this paragraph. The amount determined under subdivision (i) is $86 ($3,000 × 40% × (−7.2%)), and the amount determined under subdivision (ii) is $240 ($3,000 × 80% × 10%).
Overview

Q–1: What is the effect of Internal Revenue Code section 280G?

A–1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

   (b) The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q–2: What is a parachute payment for purposes of section 280G?

A–2: (a) The term parachute payment means any payment (other than an exempt payment described in Q/A–5) that—

   (1) Is in the nature of compensation;
   (2) Is made or is to be made to (or for the benefit of) a disqualified individual;
   (3) Is contingent on a change—

      (i) In the ownership of a corporation;
      (ii) In the effective control of a corporation;
      (iii) In the ownership of a substantial portion of the assets of a corporation; and
   (4) Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A–2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

   (b) Hereinafter, a change referred to in paragraph (a)(3) of this A–2 is generally referred to as a change in ownership or control.

Effective date of regulations—Q/A–48

Effective date of regulations—Q/A–48

Overview

Q–1: What is the effect of Internal Revenue Code section 280G?

A–1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

   (b) The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q–2: What is a parachute payment for purposes of section 280G?

A–2: (a) The term parachute payment means any payment (other than an exempt payment described in Q/A–5) that—

   (1) Is in the nature of compensation;
   (2) Is made or is to be made to (or for the benefit of) a disqualified individual;
   (3) Is contingent on a change—

      (i) In the ownership of a corporation;
      (ii) In the effective control of a corporation; or
      (iii) In the ownership of a substantial portion of the assets of a corporation; and
   (4) Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A–2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

   (b) Hereinafter, a change referred to in paragraph (a)(3) of this A–2 is generally referred to as a change in ownership or control. For a discussion of the application of paragraph (a)(1), see Q/A–11 through Q/A–14; paragraph (a)(2), Q/A–15 through Q/A–21; paragraph (a)(3),
Q–2: What is an excess parachute payment for purposes of section 280G?

A–2: The term excess parachute payment means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, see Q/A–37. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, see Q/A–38 through Q/A–44.

Q–3: What is the effective date of section 280G and this section?

A–3: In general, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Section 280G also applies to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. This section applies to any payment that is contingent on a change in ownership or control and the change in ownership or control occurs on or after January 1, 2004. For a discussion of the application of the effective date, see Q/A–47 and Q/A–48.

Exempt Payments

Q–5: Are some types of payments exempt from the definition of the term parachute payment?

A–5: (a) Yes, the following five types of payments are exempt from the definition of parachute payment—

(1) Payments with respect to a small business corporation (described in Q/A–6 of this section);

(2) Certain payments with respect to a corporation no stock in which is readily tradeable on an established securities market (or otherwise) (described in Q/A–6 of this section);

(3) Payments to or from a qualified plan (described in Q/A–8 of this section);

(4) Certain payments made by a corporation undergoing a change in ownership or control that is described in any of the following sections of the Internal Revenue Code: section 501(c) (but only if such organization is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, or if the organization is described in section 501(c)(1) or section 501(c)(21)), section 501(d), or section 529, collectively referred to as tax-exempt organizations (described in Q/A–6 of this section); and

(5) Certain payments of reasonable compensation for services to be rendered on or after the change in ownership or control (described in Q/A–9 of this section).

(b) Deductions for payments exempt from the definition of parachute payment are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of Q/A–30 of this section.

Q–6: Which payments with respect to a corporation referred to in paragraph (a)(1), (a)(2), or (a)(4) of Q/A–5 of this section are exempt from the definition of parachute payment?

A–6: (a) The term parachute payment does not include—

(1) Any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) would qualify as a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof), without regard to whether the corporation had an election to be treated as a
corporation under section 1361 in effect on the date of the change in ownership or control:

(2) Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A–6) if—

(i) Immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise; and

(ii) The shareholder approval requirements described in Q/A–7 of this section are met with respect to such payment; or

(3) Any payment to a disqualified individual made by a corporation which is a tax-exempt organization (as defined in paragraph (a)(4) of Q/A–5 of this section), but only if the corporation meets the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control.

(b) For purposes of paragraph (a)(1) of this A–6, the members of an affiliated group are not treated as one corporation.

(c) The requirements of paragraph (a)(2)(i) of this A–6 are not met with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradeable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity. For this purpose, gross fair market value means the value of the assets of the entity, determined without regard to any liabilities associated with such assets. If a corporation is a member of an affiliated group (which group is treated as one corporation under A–46 of this section), the requirements of paragraph (a)(2)(i) of this A–6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

(d) For purposes of paragraph (a)(2)(i) of this A–6, the term stock does not include stock described in section 1504(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock.

(e) For purposes of paragraph (a)(2)(i) of this A–6, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock.

(f) For purposes of paragraph (a)(2)(i) of this A–6, the term established securities market means an established securities market as defined in §1.897–1(m).

(g) The following examples illustrate the application of this exemption:

Example 1. A small business corporation (within the meaning of paragraph (a)(1) of this A–6) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee’s base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example 2. Assume the same facts as in Example 1, except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this A–6. If no stock in the corporation is readily tradeable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A–7 of this section are met, the payments are not parachute payments.

Example 3. Stock of Corporation S is owned by Corporation P, stock in which is readily tradeable on an established securities market. The Corporation S stock equals or exceeds one third of the total gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. Corporation S makes severance payments to several of its highly-compensated individuals that are parachute payments under section 280G and Q/A–2 of this section. Because stock in Corporation P is readily tradeable on an established securities market, the payments are not exempt from the definition of parachute payments under this A–6.

Example 4. A is a corporation described in section 501(c)(3), and accordingly, its net earnings are prohibited from inuring to the
benefit of any private shareholder or individual. A transfers substantially all of its assets to another corporation resulting in a change in ownership or control. Contingent on the change in ownership or control, A makes a payment that, but for the potential application of the exemption described in A–8(a)(4), would constitute a parachute payment. However, one or more aspects of the transaction that constitutes the change in ownership or control causes A to fail to be described in section 501(c)(3). Accordingly, A fails to meet the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control, as required by this A–6. As a result, the payment made by A that was contingent on the change in ownership or control is not exempt from the definition of parachute payment under this A–6.

Example 5. B is a corporation described in section 501(c)(15). B does not meet the definition of a tax-exempt organization because section 501(c)(15) does not expressly prohibit inurement of B’s net earnings to the benefit of any private shareholder or individual. Accordingly, if B has a change in ownership or control and makes a payment that would otherwise meet the definition of a parachute payment, such payment is not exempt from the definition of the term parachute payment for purposes of this A–6.

Q–7: How are the shareholder approval requirements referred to in paragraph (a)(2)(i) of Q/A–6 of this section met?

A–7: (a) General rule. The shareholder approval requirements referred to in paragraph (a)(2)(i) of Q/A–6 of this section are met with respect to any payment if—

(1) Such payment is approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote (as described in this A–7) immediately before the change in ownership or control; and

(2) Before the vote, there was adequate disclosure to all persons entitled to vote (as described in this A–7) of all material facts concerning all material payments which (but for Q/A–6 of this section) would be parachute payments with respect to a disqualified individual.

(b) Voting requirements—(1) General rule. The vote described in paragraph (a)(1) of this A–7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. Except as otherwise provided in this A–7, the normal voting rules of the corporation are applicable. Thus, for example, an optionholder is generally not permitted to vote for purposes of this A–7. For purposes of this A–7, the vote can be on less than the full amount of the payment(s) to be made. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. The total payment(s) submitted for shareholder approval, however, must be separately approved by the shareholders. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment to a disqualified individual that would be a parachute payment but for Q/A–6 of this section.

(2) Special rule. A vote to approve the payment does not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record as of any day within the six-month period immediately prior to and ending on date of the change in ownership or control, provided the disclosure requirements described in paragraph (c) of this A–7 are met.

(3) Entity shareholder. (i) Approval of a payment by any shareholder that is not an individual (an entity shareholder) generally must be made by the person authorized by the entity shareholder to approve the payment. See paragraph (b)(4) of this A–7 if the person so authorized by the entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A–7 are not met.

(ii) However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity...
shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder entitled to vote. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation undergoing a change in ownership or control. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote. For purposes of this (b)(3)(ii), stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity shareholder. For this purpose, gross fair market value means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.

(4) Disqualified individuals and attribution of stock ownership. In determining the persons entitled to vote referred to in paragraph (a)(1) or (b)(3) of this A–7, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not considered in determining whether the more than 75 percent vote has been obtained under this A–7 if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A–7 are not met, and a brief description of each payment (e.g., accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(d) Corporation without shareholders. If a corporation does not have shareholders, the exemption described in Q–A–6(a)(2) of this section and the shareholder approval requirements described in this A–7 do not apply.

(e) Examples. The following examples illustrate the application of this A–7:
Example 1. Corporation S has two shareholders—Corporation P, which owns 76 percent of the stock of Corporation S, and A, a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A–7 are not met. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation S equals or exceeds one third of the gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to certain officers of Corporation S in excess of 3 times each officer’s base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock entitled to vote of Corporation P and the disclosure rules of paragraph (a)(2) of this A–7 are complied with, the payments are exempt from the shareholder approval requirements of this A–7 are met, and the payments are approved by the general partner and the disclosure requirements described in paragraph (a)(2) of this A–7 are met, the shareholder approval requirements of this A–7 are not met. If the payments are made to A, a disqualified individual with respect to Corporation A, or "no" on the sale and "yes" to paying parachute payments to A, a disqualified individual with respect to Corporation A, or "no" on the sale and "no" to paying parachute payments to A. 

(ii) Because the approval of the change in ownership or control is conditioned on the approval of the payments to A, the shareholder approval requirements of this A–7 are not satisfied. If the payments are made to A, the payments are not exempt from the definition of parachute payment pursuant to Q/A-6 of this section.

(iii) Assume the same facts as in paragraph (i) of this Example 2, except that the acquisition agreement between Corporation X and Corporation Y states that the acquisition is approved only if there are no parachute payments made to A. If the shareholder approval and the disclosure requirements described in this A–7 are met, the payments will not be parachute payments. Alternatively, if the shareholders do not approve the payments, the payments cannot be made (or retained). Thus, the transaction is not conditioned on the approval of the parachute payments. If the payments are made and the requirements of this A–7 are met, the payments are exempt from the definition of parachute payment pursuant to Q/A-6 of this section.

Example 3. Corporation M is wholly owned by Partnership P. No interest in either M or P is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation M equals or exceeds one third of the gross fair market value of the assets of Partnership P, and thus, represents a substantial portion of the assets of Partnership P. Corporation M undergoes a change in ownership or control. Partnership P has one general partner and 200 limited partners. The general partner is not a disqualified individual. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments that would be parachute payments if the shareholder approval requirements of this A–7 are not met are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A–7 are complied with, the shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of parachute payment pursuant to A–6 of this section.

Example 4. Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A and would receive parachute payments if the shareholder approval requirements of this A–7 are not met. No stock of Corporation A is readily tradeable on an established securities market (or otherwise). Corporation A undergoes a change in ownership or control. Contingent on the change in ownership or control, severance payments are payable to X and Y that are in excess of 3 times each individual’s base amount. To determine whether the shareholder approval requirements of paragraph (a)(1) of this A–7 are satisfied regarding the payments to X and Y, the stock of X and Y is not considered outstanding, and X and Y are not entitled to vote.

Example 5. Assume the same facts as in Example 4, except that adequate disclosure of all material facts (within the meaning of paragraph (a)(2) of this A–7) to all shareholders entitled to vote, 80 percent of the shareholders who are entitled to vote approve the payments to X and Y. Because more than 75 percent of the shareholders holding outstanding stock who were entitled to vote did not approve the payments to X and Y, the payments cannot be made.

Example 6. Assume the same facts as in Example 4 except that disclosure of all the material facts (within the meaning of paragraph (a)(2) of this A–7) regarding the payments to X and Y is made to two of Corporation A’s shareholders, who collectively own 80 percent of Corporation A’s stock entitled to vote and approve the payment. Both shareholders approve the payments. Assume further that no adequate disclosure of the material facts regarding the payments to X and Y is made to other Corporation A shareholders who are entitled to vote within the meaning of this A–7. Notwithstanding that 80 percent of the shareholders entitled to vote approve
the payments, because disclosure regarding the payments to X and Y is not made to all of Corporation A’s shareholders who were entitled to vote, the disclosure requirements of paragraph (a) of this A–7 are not met, and the payments are not exempt from the definition of parachute payment pursuant to Q/A–6.

Example 7. Corporation C has three shareholders—Partnership, which owns 20 percent of the stock of Corporation C; A, an individual who owns 60 percent of the stock of Corporation C; and B, an individual who owns 20 percent of Corporation C. Stock of Corporation C does not represent a substantial portion of the assets of Partnership. No interest in either Partnership or Corporation C is readily tradeable on an established securities market (or otherwise). P, a one-third partner in Partnership, is a disqualified individual with respect to Corporation C. Corporation C undergoes a change in ownership or control. Contingent on the change, a severance payment is payable to P in excess of 3 times P’s base amount. To determine the persons who are entitled to vote referred to in paragraph (a)(1) of this A–7, one-third of the stock held by Partnership is not considered outstanding stock. If P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock. However, Partnership is permitted to appoint an equity interest holder in Partnership (who is not a disqualified individual) who would receive a parachute payment if the requirements of this A–7 are not met, to vote the two-thirds of the shares held by Partnership that are otherwise entitled to be voted.

Example 8. X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). Each individual has a base amount of $100,000. Corporation E undergoes a change in ownership or control. Contingent on the change, a severance payment of $400,000 is payable to X; $600,000 is payable to Y; and $1,000,000 is payable to Z. Corporation E provides each Corporation E shareholder entitled to vote (as determined under this A–7) with a ballot listing and describing the payments of $400,000 to X; $600,000 to Y; and $1,000,000 to Z and the triggering event that generated the payments. Next to each name and corresponding amount on the ballot, Corporation E requests approval (with a “yes” and “no” box) of each total payment to be made to each individual and states that if the payment is not approved the payment will not be made. Adequate disclosure, within the meaning of this A–7 is made to each shareholder entitled to vote under this A–7. More than 75 percent of the Corporation E shareholders who are entitled to vote under paragraph (a)(1) of this A–7 approve each payment to each individual. The shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of parachute payment pursuant to A–6 of this section.

Example 9. Assume the same facts as in Example 8 except that the ballot does not request approval of each total payment to each individual separately. Instead, the ballot states that $2,000,000 in payments will be made to X, Y, and Z and requests approval of the $2,000,000 payments. Assuming the triggering event and amount of the payments to X, Y, and Z are separately described to the shareholders entitled to vote under this A–7, the shareholder approval requirements of paragraph (a)(1) of this A–7 are met, and the payments are exempt from the definition of parachute payment pursuant to A–6 of this section.

Example 10. B, an employee of Corporation X, is a disqualified individual with respect to Corporation X. Stock of Corporation X is not readily tradeable on an established securities market (or otherwise). Corporation X undergoes a change in ownership or control. B’s stock options will vest and B will receive severance and bonus payments. Contingent on the change in ownership or control, B’s stock options with a fair market value of $500,000 immediately vest, $200,000 of which is contingent on the change, and B will receive a $200,000 bonus payment and a $400,000 severance payment. Corporation X distributes a ballot to every shareholder of Corporation X who immediately before the change is entitled to vote as described in this A–7. The ballot contains adequate disclosure of all material facts and lists the following payments to be made to B: The contingent payment of $200,000 attributable to options, a $200,000 bonus payment, and a $400,000 severance payment. The ballot requests shareholder approval of the $200,000 bonus payment to B and states that whether or not the $200,000 bonus payment is approved, B will receive $200,000 attributable to options and a $400,000 severance payment. More than 75 percent of the shareholders entitled to vote as described by this A–7 approve the $200,000 bonus payment to B. The shareholder approval requirements of this A–7 are met, and the $200,000 payment is exempt from the definition of parachute payment pursuant to A–6 of this section.

Q–8: Which payments under a qualified plan are exempt from the definition of parachute payment?

A–8: The term parachute payment does not include any payment to or from—
(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);
(b) An annuity plan described in section 403(a);
(c) A simplified employee pension (as defined in section 408(k)); or
(d) A simple retirement account (as defined in section 408(p)).

Q–9: Which payments of reasonable compensation are exempt from the definition of parachute payment?
A–9: Except in the case of securities violation parachute payments, the term parachute payment does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. See Q/A–37 of this section for the definition and treatment of securities violation parachute payments. See Q/A–40 through Q/A–44 of this section for rules on determining amounts of reasonable compensation.

Payor of Parachute Payments

Q–10: Who may be the payor of parachute payments?
A–10: Parachute payments within the meaning of Q/A–2 of this section may be paid, directly or indirectly, by—
(i) The corporation referred to in paragraph (a)(3) of Q/A–2 of this section;
(ii) A person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation’s assets; or
(iii) Any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q–11: What types of payments are in the nature of compensation?
A–11: (a) General rule. For purposes of this section, all payments—in whatever form—are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, (including the value of accelerated vesting under Q/A–24(c), or a transfer of property. However, payments in the nature of compensation do not include attorney’s fees or court costs paid or incurred in connection with the payment of any amount described in paragraphs (a)(1), (2), and (3) of Q/A–2 of this section or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

(b) When payment is considered to be made. Except as otherwise provided in A–11 through Q/A–13 of this section, a payment in the nature of compensation is considered made (and is subject to the excise tax under section 4999) in the taxable year in which it is includible in the disqualified individual’s gross income or, in the case of fringe benefits and other benefits excludible from income, in the taxable year the benefits are received.

(c) Prepayment rule. Notwithstanding the general rule described in paragraph (b) of this A–11, a disqualified individual may, in the year of the change in ownership or control, or any later year, prepay the excise tax under section 4999, provided that the payor and disqualified individual treat the payment of the excise tax consistently and the payor satisfies its obligations under section 4999(c) in the year of prepayment. The prepayment of the excise tax for purposes of section 4999 must be based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid (calculated using the discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and regulations thereunder; see Q/A–32)). For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, it

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is permissible to make a reasonable assumption regarding this variable rate. A disqualified individual is not required to adjust the excise tax paid under this paragraph (c) merely because the interest rates in the future are not the same as the rate used for purposes of projecting the future value of the payment. However, a disqualified individual may not apply this paragraph (c) of this A–11 to a payment to be made in cash if the present value of the payment would be considered not reasonably ascertainable under section 3121(v) and § 31.3121(v)(2)–1(e)(4) of this Chapter or to a payment related to health benefits or coverage. The Commissioner may provide additional guidance regarding the applicability of this paragraph (c) to certain payments in published guidance of general applicability under § 601.601(d)(2) of this Chapter.

(d) Transfers of property. Transfers of property are treated as payments for purposes of this A–11. See Q/A–12 of this section for rules on determining when such payments are considered made and the amount of such payments. See Q/A–13 of this section for special rules on transfers of stock options.

(e) The following example illustrates the principles of this A–11:

Example. D is a disqualified individual with respect to Corporation X. D has a base amount of $100,000 and is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. A change in ownership or control of Corporation X occurs on May 1, 2005, and the $200,000 payment is made to D at the time of the change in ownership or control. The $400,000 payment is to be made on October 1, 2010. Corporation X and D agree that D will prepay the excise tax and X will satisfy its obligations under section 4999 with respect to the $50,000, in addition to the $32,000 withholding required with respect to the $200,000 payment.

Q–12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A–12: (a) Except as provided in this A–12 and Q/A–13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83 and the regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in § 1.83–3(a)) to the disqualified individual and becomes substantially vested (as defined in § 1.83–3(b) and (j)) in such individual. The amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in § 1.83–3(1)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b) An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A–12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, for purposes of this section, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c) See Q/A–13 of this section for rules on applying this A–12 to transfers of stock options.

(d) The following example illustrates the principles of this A–12:

Example. On January 1, 2006, Corporation M gives to A, a disqualified individual, a bonus of 100 shares of Corporation M stock in connection with the performance of services to Corporation M. Under the terms of the bonus arrangement A is obligated to return the
Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 2009, or there is a change in ownership or control of Corporation M before that date. A’s rights in the stock are treated as substantially nonvested (within the meaning of §1.83–3(b)) during that period because A’s rights in the stock are subject to a substantial risk of forfeiture (within the meaning of §1.83–3(c)) and are nontransferable (within the meaning of §1.83–3(d)). On January 1, 2008, a change in ownership or control of Corporation M occurs. On that day, the fair market value of the Corporation M stock is $250 per share. Because A’s rights in the Corporation M stock become substantially vested (within the meaning of §1.83–3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to $25,000 (100 x $250). See Q/A–38 through 41 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q–13: How are transfers of statutory and nonstatutory stock options treated?

A–13: (a) For purposes of this section, an option (including an option to which section 421 applies) is treated as property that is transferred when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in §1.83–7(b)). For purposes of this A–13, vested means substantially vested within the meaning of §1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c). Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: The difference between the option’s exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. Thus, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without regard to whether such option has an ascertainable fair market value. For purposes of this A–13, valuation may be determined by any method prescribed by the Commissioner in published guidance of general applicability under §601.601(d)(2) of this Chapter.

(b) Any money or other property transferred to the disqualified individual on the exercise, or as consideration on the sale or other disposition, of an option described in paragraph (a) of this A–13 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under Q/A–11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer is reduced by the amount of the payment described in paragraph (a) of this A–13 treated as an excess parachute payment.

Q–14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A–14: Yes, to the extent not otherwise taken into account under Q/A–12 and Q/A–13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q–15: Who is a disqualified individual?

A–15: (a) For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the disqualified individual determination period (as defined in Q/A–20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation—

1. A shareholder (but see Q/A–17 of this section);
2. An officer (see Q/A–18 of this section); or
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(3) A highly-compensated individual (see Q/A–19 of this section).

(b) For purposes of this A–15, a director is a disqualified individual with respect to a corporation if, at any time during the disqualified individual determination period, the director is, with respect to the corporation, a shareholder (see Q/A–17 of this section), an officer (see Q/A–18 of this section), or a highly-compensated individual (see Q/A–19 of this section).

(c) For purposes of this A–15, an individual who is an employee or independent contractor of a corporation other than the corporation undergoing a change in ownership or control is disregarded for purposes of determining who is a disqualified individual if such individual is employed by the corporation undergoing the change in ownership or control only on the last day of the disqualified individual determination period. Thus, for example, assume that E is an employee of Corporation X, that Y is acquired by Corporation X, and that Y undergoes a change in ownership or control. If E becomes an employee of Y on the date of the acquisition, in determining the disqualified individuals with respect to Y, E is disregarded under this paragraph (c).

Q–16: Is a personal service corporation treated as an individual?

A–16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, is treated as an individual.

(b) The following example illustrates the principles of this A–16:

Example. Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of highly-compensated individuals of Corporation M as determined under A–19 of this section. Thus, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q–17: Are all shareholders of a corporation considered shareholders for purposes of paragraphs (a)(1) and (b) of Q/A–15 of this section?

A–17: (a) No. Only an individual who owns stock of a corporation with a fair market value that exceeds 1 percent of the fair market value of the outstanding shares of all classes of the corporation’s stock is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation if such individual is an officer (see Q/A–18) or highly-compensated individual (see Q/A–19) with respect to the corporation.

(b) For purposes of determining the amount of stock owned by an individual for purposes of paragraph (a) of this A–17, the constructive ownership rules of section 318(a) apply. Stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by §§1.83–3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. Solely for purposes of determining the amount of stock owned by an individual for purposes of this A–17, mutual and cooperative corporations are treated as having stock.

(c) The following examples illustrates the principles of this A–17:

Example 1. E, an employee of Corporation A, received options under Corporation A’s Stock Option Plan. E’s stock options vest three years after the date of grant. E is not an officer or highly compensated individual during the disqualified individual determination period. E does not own, and is not considered to own under section 318, any other Corporation A stock. Two years after the options are granted to E, all of Corporation A’s stock is acquired by Corporation B. Under Corporation A’s Stock Option Plan, E’s options are converted to Corporation B options and the vesting schedule remains the same. Under paragraph (b) of this A–17, the stock underlying the unvested options held by E on the date of the change in ownership or control is not considered owned by E. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the
outstanding shares of all classes of Corporation A and E is not an officer or highly-compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q/A–15 of this section with respect to Corporation A.

Example 2. Assume the same facts as in Example 1, except that Corporation A’s Stock Option Plan provides that all unvested options will vest immediately on a change in ownership or control. Under paragraph (b) of this A–17, the stock underlying the options that vest on the change in ownership or control is considered owned by E. If the stock considered owned by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock (including for this purpose, all stock owned or constructively owned by all shareholders, provided that no share of stock is counted more than once), E is a disqualified individual within the meaning of Q/A–15 of this section with respect to Corporation A.

Example 3. Assume the same facts as in Example 1 except that E received nonstatutory stock options that are exercisable for stock subject to a substantial risk of forfeiture under section 83. Assume further that under Corporation A’s Stock Option Plan, the nonstatutory options will vest on a change in ownership or control. Under paragraph (b) of this A–17, E is not considered to own the stock underlying the options that vest on the change in ownership or control because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock and E is not an officer or highly compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q/A–15 of this section with respect to Corporation A.

Q–18: Who is an officer?

A–18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as the source of the individual’s authority, the term for which the individual is elected or appointed, and the nature and extent of the individual’s duties). Any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of an officer. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction.

(b) An individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q/A–46 of this section is treated as an officer of such one corporation.

(c) No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group) are treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A–20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A–21 of this section) paid during the disqualified individual determination period.

(d) In determining the total number of employees of a corporation for purposes of this A–18, employees are not counted if they normally work less than 17½ hours per week (as defined in section 414(q)(5)(B) and the regulations thereunder) or if they normally work during not more than 6 months during any year (as defined in section 414(q)(5)(C) and the regulations thereunder). However, an employee who is
Q–19: Who is a highly-compensated individual?

A–19: (a) For purposes of this section, a highly-compensated individual with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A–21 of this section) earned during the disqualified individual determination period (as defined in Q/A–20 of this section). For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A–20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly-compensated individual.

(b) An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual’s trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

(c) The total number of employees of a corporation for purposes of this A–19 is determined in accordance with Q/A–18(d) of this section. However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q–20: What is the disqualified individual determination period?

A–20: The disqualified individual determination period is the twelve-month period prior to and ending on the date of the change in ownership or control of the corporation.

Q–21: How is compensation defined for purposes of determining who is a disqualified individual?

A–21: (a) For purposes of determining who is a disqualified individual, the term compensation means the compensation which was earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs (changed corporation), for a predecessor entity, or for a related entity. Such compensation is determined without regard to sections 125, 132(f)(4), 402(e)(3), and 402(h)(1)(B). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity, and amounts credited under a non-qualified deferred compensation plan.

(b) For purposes of this A–21, a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term related entity includes—

(1) All members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity;

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity;

(3) All members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and

(4) Any other entities required to be aggregated with the changed corporation or a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c) For purposes of Q/A–18 and Q/A–19 of this section, compensation that was contingent on the change in ownership or control and that was payable in the
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year of the change is not treated as compensation.

Contingent on Change in Ownership or Control

Q–22: When is a payment contingent on a change in ownership or control?

A–22: (a) In general, a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. (But see Q/A–23 of this section regarding payments under agreements entered into after a change in ownership or control.) A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. For purposes of this A–22, vested means the payment is substantially vested within the meaning of §1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture as defined by section 83(c).

(b)(1) For purposes of paragraph (a), a payment is treated as contingent on a change in ownership or control if—

(i) The payment is contingent on an event that is closely associated with a change in ownership or control;

(ii) A change in ownership or control actually occurs; and

(iii) The event is materially related to the change in ownership or control.

(2) For purposes of paragraph (b)(1)(i) of this A–22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation’s stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation’s stock on an established securities market; the acquisition of more than 5 percent of the corporation’s stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual’s employment; a significant reduction in the disqualified individual’s job responsibilities; and a change in ownership or control as defined in the disqualified individual’s employment agreement (or elsewhere) that does not meet the definition of a change in ownership or control described in Q/A–27, 28, or 29 of this section. Whether other events are treated as closely associated with a change in ownership or control is based on all the facts and circumstances of the particular case.

(3) For purposes of determining whether an event (as described in paragraph (b)(2) of this A–22) is materially related to a change in ownership or control, the event is presumed to be materially related to a change in ownership or control if such event occurs within the period beginning one year before and ending one year after the date of the change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or control, the event is presumed not materially related to the change in ownership or control. A payment does not fail to be contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control). Similarly, a payment that is treated as contingent
on a change in ownership or control because it is contingent on a closely associated event does not fail to be treated as contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control).

(c) A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change in ownership or control (or the occurrence of an event that is closely associated with and materially related to a change in ownership or control within the meaning of paragraph (b)(1) of this A–22), accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that is vested without regard to the change in ownership or control, the payment may be treated as contingent on the change. See Q/A–24 of this section regarding the portion of a payment that is so treated. See also Q/A–8 of this section regarding the exemption for certain payments under qualified plans and Q/A–40 of this section regarding the treatment of a payment as reasonable compensation.

(d) A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e) The following examples illustrate the principles of this A–22:

Example 1. A corporation grants a stock appreciation right to a disqualified individual, A, more than one year before a change in ownership or control. After the stock appreciation right vests and becomes exercisable, a change in ownership or control of the corporation occurs, and A exercises the right. Assuming neither the granting nor the vesting of the stock appreciation right is contingent on a change in ownership or control, the payment made on exercise is not contingent on the change in ownership or control.

Example 2. A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B’s employment with the corporation terminates at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B’s employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B’s termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership under paragraph (a) of this A–22. This is true even though B’s termination of employment is presumed not to be, and in fact may not be, materially related to the change in ownership or control.

Example 3. A contract between a corporation and C, a disqualified individual, provides that a payment will be made to C if C’s employment is terminated at any time over the succeeding 3 years (without regard to whether or not there is a change in ownership or control). Eighteen months after the contract is entered into, a change in the ownership or control of the corporation occurs. Six months after the change in ownership or control, C’s employment is terminated and the payment is made to C. Termination of employment is considered an event closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership or control, the termination of C’s employment is presumed to be materially related to the change in ownership or control under paragraph (b)(3) of this A–22. If this presumption is not successfully rebutted, the payment will be treated as contingent on the change in ownership or control under paragraph (b) of this A–22.

Example 4. A contract between a corporation and a disqualified individual, D, provides that a payment will be made to D upon the onset of a tender offer for shares of the corporation’s stock. A tender offer is made on December 1, 2008, and the payment is made to D. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 2009, which results in a change in the ownership or control of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership or control of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership or control. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership or control. If no change in ownership or control had occurred, the payment would not be
treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q–A–37 of this section if the contract violated a generally enforced securities law or regulation.

Example 5. A contract between a corporation and a disqualified individual, E, provides that a payment will be made to E if the corporation’s level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation’s level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in ownership or control of the corporation occurs and within one year after the date of the change of ownership or control, the corporation’s level of product sales or profits reaches a specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change in ownership or control, the payment will not be treated as contingent on a change in ownership or control.

Q–23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?

A–23: (a) No. Payments are not treated as contingent on a change in ownership or control if they are made (or are to be made) pursuant to an agreement entered into after the change (a post-change agreement). For this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change is considered to have been entered into before the change. (See Q–A–9 of this section regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.) If an individual has a right to receive a payment that would be a parachute payment if made under an agreement entered into prior to a change in ownership or control (pre-change agreement) and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement. To the extent payments under the agreement have the same value as the payments under the pre-change agreement, such payments retain their character as parachute payments subject to this section.

(b) The following examples illustrate the principles of this A–23:

Example 1. Assume that a disqualified individual is an employee of a corporation. A change in ownership or control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Because the agreement is entered into after the change in ownership or control occurs, payments to be made under the agreement are not treated as contingent on the change.

Example 2. Assume the same facts as in Example 1 except that the agreement between the disqualified individual and the acquiring company is executed after the change in ownership or control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in ownership or control pursuant to Q/A–22 of this section. However, see Q/A–9 of this section regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Example 3. Assume the same facts as in Example 1, except that prior to the change in ownership or control, the individual and corporation enter into an agreement under which the individual will receive parachute payments in the event of a change in ownership or control of the corporation. After the change, the individual agrees to give up the right to payments under the pre-change agreement that would be parachute payments if made, in exchange for compensation under a new agreement with the acquiring corporation. Because the individual gave up the right to parachute payments under the pre-change agreement in exchange for other payments under the post-change agreement, payments in an amount equal to the parachute payments under the pre-change agreement are treated as contingent on the change in ownership or control under this A–23. Because the post-change agreement was entered into after the change, payments in excess of this amount are not treated as parachute payments.

Q–24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?
A–24: (a)(1) General rule. Yes. If the payment is a transfer of property, the amount of the payment is determined under Q/A–12 or Q/A–13 of this section. For all other payments, the amount of the payment is determined under Q/A–11 of this section. However, in certain circumstances, described in paragraphs (b) and (c) of this A–24, only a portion of the payment is treated as contingent on the change. Paragraph (b) of this A–24 applies to a payment that is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. Paragraph (c) of this A–24 applies to a payment that becomes vested as a result of the change in ownership or control to the extent that—

(i) Without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and

(ii) The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

The portion of the payment subject to paragraph (c) of this A–24 that is treated as contingent on the change in ownership or control is the amount described in paragraph (b) of this A–24, plus an amount, as determined in paragraph (c)(4) of this A–24, to reflect the lapse of the obligation to continue to perform services. In no event can the portion of the payment treated as contingent on the change in ownership or control under this paragraph (c) exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment.
a restriction on restricted stock is considered to significantly increase the value of a payment.

(4) The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(2) of this A-24) is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual’s right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (c)(4) applies to the accelerated vesting of a payment in the nature of compensation even if the time at which the payment is made is not accelerated. In such a case, the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual’s right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested.

(d) Application of this A-24 to certain payments—(1) Benefits under a nonqualified deferred compensation plan. In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (b) of this A-24 applies to the extent benefits under the plan are vested without regard to the change in ownership or control. Paragraph (c) of this A-24 applies to the extent benefits under the plan become vested as a result of the change in ownership or control and are attributable, at least in part, to the performance of services prior to vesting. Any other payment of benefits under a nonqualified deferred compensation plan is a payment in the nature of compensation subject to the general rule of paragraph (a) of this A-24 and the rules in Q/A-11 of this section.

(2) Employment agreements. The general rule of paragraph (a) of this A-24 (and not the rules in paragraphs (b) or (c)) applies to the payment of amounts due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services (or refraining from the performance of services) during any period that begins after the date of termination of employment or change in ownership or control, as applicable. For purposes of this paragraph (d)(2) of this A-24, an employment agreement means an agreement between an employee or independent contractor and employer or service recipient which describes, among other things, the amount of compensation or remuneration payable to the employee or independent contractor. See Q/A-42(b) and 44 of this section for the treatment of the remaining amounts of salary under an employment agreement.

(3) Vesting due to an event other than services. Neither paragraph (b) nor (c) of this A-24 applies to a payment if (without regard to the change in ownership or control) vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in ownership or control. In such circumstances, the full amount of the accelerated payment is treated as contingent on the change in ownership or control under paragraph (a) of this A-24. However, see Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

(e) Present value. For purposes of this A-24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(f) Examples. The following examples illustrate the principles of this A-24:

Example 1. (i) Corporation maintains a qualified plan and a nonqualified supplemental retirement plan (SERP) for its executives. Benefits under the SERP are not paid to participants until retirement. E, a disqualified individual with respect to Corporation, has a vested account balance of $500,000 under the SERP. A change in ownership or control of Corporation occurs. The SERP provides that in the event of a change in ownership or control, all vested accounts will be paid to SERP participants.

(ii) Because E was vested in $500,000 of benefits under the SERP prior to the change in ownership or control and the change merely accelerated the time at which the payment was made to E, only a portion of the payment, as determined under paragraph (b) of
Example 1. (i) On January 15, 2006, a corporation D employs F. F is then entitled to receive a retirement bonus of $500,000 to be paid on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that, contingent on the change in ownership or control of the corporation during the 5-year period, on January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment ($500,000) is made on that date to F. Under these facts, the payment of $500,000 was contingent only on F’s performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment, as determined under paragraph (c) of this A–24, is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment ($500,000) exceeds the present value of the payment absent the acceleration, which is the amount reflecting the lapse of time prior to the change, and the entire $70,000 payment is contingent on the change in ownership or control.

(ii) Assume the same facts as in paragraph (i) of this Example 1, except that in addition to the pay, out of the vested account balance of $500,000 on the change in ownership or control, an additional $70,000 will be credited to F’s account and included in the payment to F. Because the $500,000 was vested without regard to the change in ownership or control, the entire $70,000 payment is credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D’s vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

Example 3. (i) On January 15, 2006, a corporation E employs a disqualified individual. E is also a party to a deferred compensation plan that is not a qualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which E would have received E’s vested account balance absent the change in ownership or control is uncertain. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment ($500,000) exceeds the present value of the payment absent the acceleration, which is the amount reflecting the lapse of time prior to the change, and the entire $70,000 payment is contingent on the change in ownership or control.
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(ii) Assume the same facts as in paragraph (i) of this Example 3, except that the retention bonus will vest on the change in ownership or control, but will not be paid until January 15, 2011 (the original date in the contract). Because the payment of $500,000 was contingent only on F’s performance of services for a specified period and is attributable to the performance of services before the change in ownership or control, only a portion of the $500,000 payment is treated as contingent on the change in ownership or control as determined under paragraph (c) of this A–24. Because there is accelerated vesting of the bonus, the portion of the payment treated as contingent on the change is the amount described in paragraph (b) of this A–27, which is $0 under these facts, plus an amount reflecting the lapse of the obligation to continue to perform services which is $93,573 (1 percent × 23 months × $406,838 (the present value of a $500,000 payment)).

Example 4. (i) On January 15, 2006, a corporation grants to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation’s stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual’s rights in the stock are treated as substantially nonvested (within the meaning of §1.83–3(b) and (j)) during that period. On January 15, 2009, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is $500,000.

(ii) Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment, as determined under paragraph (c) of this A–24, is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 ($500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be $560,000, the amount of the accelerated payment. The present value on January 15, 2009, of a $500,000 payment to be made on January 15, 2011, is $496,838. Thus, the portion of the payment treated as contingent on the change is $238,162, the sum of $93,162 ($500,000 – $406,838) plus $115,000 (1 percent × 23 months × $500,000), the amount reflecting the lapse of the obligation to continue to perform services.

Example 5. (i) On January 15, 2006, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation’s stock. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 2009. The options will, however, vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 2008, a change in the ownership or control of the corporation occurs and the options become vested in the individual. The value of the options on January 16, 2008, determined in accordance with §A–13, is $600,000.

(ii) The payment of the options to purchase 30,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 ($600,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $600,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $600,000 payment to be made on January 15, 2009, is $549,964. Thus, the portion of the payment treated as contingent on the change is $116,036, the sum of $50,036 ($600,000 – $549,964), plus an amount reflecting the lapse of the obligation to continue to perform services which is $66,000 (1 percent × 11 months × $600,000).

Example 6. (i) Assume the same facts as in Example 5, except that the options become vested periodically (absent a change in ownership or control), with one-third of the options vesting on January 15, 2007, 2008, and 2009, respectively. Thus, options to purchase 20,000 shares vest independently of the January 15, 2008, change in ownership or control and the options to purchase the remaining
10,000 shares vests as a result of the change in ownership or control.

(ii) The payment of the options to purchase 10,000 shares was contingent only on performance of services before the change in ownership or control. Therefore, the portion of the payment treated as contingent on the change in ownership or control is the amount by which the accelerated payment on January 16, 2008 ($200,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to perform services. At the time of the change in ownership or control, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $200,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $200,000 payment to be made on January 15, 2009, is $183,328.38. Thus, the portion of the payment treated as contingent on the change is $38,671.62, the sum of $183,328.38 ($200,000 – $183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services which is $22,000 (1 percent x 11 months x $200,000).

Example 7. Assume the same facts as in Example 5, except that the option agreement provides that the options will vest either on the corporation’s level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation’s level of profits do not reach the specified level prior to January 16, 2008. In such case, the full amount of the payment, $600,000, is treated as contingent on the change in ownership or control under paragraph (a) of this A–24. Because the payment was not contingent only on the performance of services for the corporation for a specified period, the rules of paragraph (b) and (c) of this A–24 do not apply. See Q–A–38 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Example 8. On January 1, 2005, E, a disqualified individual with respect to Corporation X, enters into an employment agreement with Corporation X under which E will be paid wages of $200,000 each year during the 5-year employment agreement. The employment agreement provides that if a change in ownership or control of Corporation X occurs, E will be paid the present value of the remaining salary under the employment agreement. On January 1, 2006, a change in ownership or control of Corporation X occurs, E is terminated, and E receives a payment of the present value of $200,000 for each of the 4 years remaining under the employment agreement. Because the payment represents future salary under an employment agreement (i.e., amounts otherwise attributable to the performance of services for periods that begin after the termination of employment), the general rule of paragraph (a) of this A–24 applies to the payment and not the rules of paragraphs (b) and (c) of this A–24. See Q–A–25(c) and 44 of this section for the treatment of the remaining payments under an employment agreement.

Presumption That Payment Is Contingent on Change

Q–25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A–25: Yes, for purposes of this section, any payment is presumed to be contingent on such a change unless the contrary is established by clear and convincing evidence if the payment is made pursuant to:

(a) An agreement entered into within one year before the date of a change in ownership or control; or

(b) An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control. In the case of an amendment described in paragraph (b) of this A–25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q–26: How may the presumption described in Q–A–25 of this section be rebutted?

A–26: (a) To rebut the presumption described in Q–A–25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular
case. Factors relevant to such a determination include, but are not limited to, the content of the agreement or amendment and the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. However, even if the presumption is rebutted with respect to an agreement, some or all of the payments under the agreement may still be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

(b) In the case of an agreement described in Q/A–25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control—

(1) A nondiscriminatory employee plan or program as defined in paragraph (c) of this A–26;

(2) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3) A contract between a corporation and an individual who did not perform services for the corporation prior to the one year period before the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

(c) For purposes of this section, the term nondiscriminatory employee plan or program means: a group term life insurance plan that meets the requirements of section 79(d); a self insured medical reimbursement plan that meets the requirements of section 105(h); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); a dependent care assistance program (within the meaning of section 129); a no-additional-cost service (within the meaning of section 132(b)); or qualified employee discount (within the meaning of section 132(c)); a qualified retirement planning services program under section 132(m); an adoption assistance program (within the meaning of section 137); and such other items as provided by the Commissioner in published guidance of general applicability under §601.601(d)(2). Payments under certain other plans are exempt from the definition of parachute payment under Q/A–8 of this section.

(d) The following examples illustrate the application of the presumption:

Example 1. A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change in ownership or control and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A–26 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

Example 2. Assume the same facts as in Example 1, except that the contract is entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership or control would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in the ownership or control of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership or control.)
control even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A–25 of this section with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change). However, payments other than the bonus under the contract still may be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

Example 3. A corporation and a disqualified individual, who is an employee of the corporation, enter into an employment contract within one year of a change in ownership or control of the corporation. Under the contract, in the event of a change in ownership or control and subsequent termination of employment, certain payments will be made to the individual. A change in ownership or control occurs, but the individual is not terminated until 2 years after the change in ownership or control. If clear and convincing evidence does not rebut the presumption described in A–25 of this section, because the payment is made pursuant to an agreement entered into within one year of the date of the change in ownership or control, the payment is presumed contingent on the change under A–25 of this section. This is true even though A’s termination of employment is presumed not to be materially related to the change in ownership or control under Q/A–22 of this section.

Change in Ownership or Control

Q–27: When does a change in the ownership of a corporation occur?
A–27: (a) For purposes of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b) of this A–27), acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A–28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A–27 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction. (See Q/A–29 for rules regarding the transfer of assets of a corporation).

(b) For purposes of paragraph (a) of this A–27, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(c) For purposes of this A–27 (and Q–28 and 29), section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by sections 1.83–3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this A–27.

(d) The following examples illustrate the principles of this A–27:
Example 1. Corporation M has owned stock with a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 2006. Corporation M acquires additional stock with a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 2006, and another additional 18 percent on February 21, 2007. As of February 21, 2007, Corporation M has acquired stock with a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 2007 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example 2. All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value or voting power) after the public offering, there is no change in the ownership of the corporation.

Example 3. Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock with a fair market value equal to 80 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock with a fair market value equal to 20 percent of the value of the stock of Corporation O. The former shareholders of Corporation P will be treated as acting as a group with the members of the corporation's board of directors who appointed or elected the members of the board of directors prior to the date of the merger.

Example 4. Assume the same facts as in Example 3, except that immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation Q stock and the former shareholders of Corporation Q own stock with a fair market value of 49 percent of the value of Corporation O stock. Assume further that prior to the merger several Corporation O shareholders also owned Corporation P stock (overlapping shareholders). In the merger, those O shareholders received additional O stock by virtue of their ownership of P stock with a fair market value of 5 percent of the value of Corporation O stock. Including the O stock attributable to the P shares, the O shareholders hold 54 percent of O after the transaction. However, those overlapping shareholders that owned both Corporation O stock and Corporation P stock prior to the merger are treated as acting as a group with the Corporation O shareholders only with respect to their ownership interest in Corporation O prior to the transaction. Therefore, because the Corporation O shareholders owned 49 percent of the value of Corporation O stock, a change in the ownership of Corporation O occurs on the date of the merger.

Example 5. A, an individual, owns stock with a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 2007, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation Q. A change in ownership of Corporation O is considered to occur on January 1, 2007 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example 6. Assume the same facts as in Example 5, except that A owns stock with a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q–28: When does a change in the effective control of a corporation occur?
A–28: (a) Notwithstanding that a corporation has not undergone a change in ownership under Q–A–27, for purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either—

(1) Any one person, or more than one person acting as a group (as determined under paragraph (e) of this A–28), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.
(b) The presumption of paragraph (a) of this A–28 may be rebutted by establishing that such acquisition or acquisitions of the corporation’s stock, or such replacement of the majority of the members of the corporation’s board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a)(1) or (2) of this A–28, a change in the effective control of a corporation is presumed not to have occurred.

(c) In no event does a change in effective control under this A–28 occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control under Q/A–27 or 29 of this section. Thus, for example, assume Corporation P transfers more than one-third of the total gross fair market value of its assets to Corporation O in exchange for 20 percent of O’s stock. Because P has undergone a change in ownership of a substantial portion of its assets under Q/A–29 of this section, O does not have a change in effective control under Q/A–28.

(d) If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A–28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A–27 of this section).

(e) For purposes of this A–28, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(f) For purposes of determining stock ownership, see Q/A–27(c).

(g) The following examples illustrate the principles of this A–28:

1. Example 1. Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 2005; 10 percent on January 10, 2006; 8 percent on February 10, 2006; 11 percent on March 1, 2007; and 8 percent on March 10, 2007. Thus, on March 10, 2007, A owns a total of 53 percent of M’s voting stock. Because A did not acquire 20 percent or more of M’s voting stock during any 12-month period, there is no presumption of a change in effective control pursuant to paragraph (a)(1) of this A–28. In addition, under these facts there is a presumption that no change in effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 2007), A’s change in ownership of Corporation M is treated as having occurred on March 10, 2007 (pursuant to Q/A–27 of this section) because A had acquired more than 50 percent of Corporation M’s voting stock as of that date.

2. Example 2. A minority group of shareholders of a corporation opposes the practices and policies of the corporation’s current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation’s shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q–29: When does a change in the ownership of a substantial portion of a corporation’s assets occur?

A–29: (a) For purposes of this section, a change in the ownership of a substantial portion of a corporation’s assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c) of this A–29), acquires (or has acquired...
during the 12-month period ending on
the date of the most recent acquisition
by such person or persons) assets from
the corporation that have a total gross
fair market value equal to or more
than one-third of the total gross fair
market value of all of the assets of the
corporation immediately prior to such
acquisition or acquisitions. For this
purpose, gross fair market value
means the value of the assets of the corpora-
tion, or the value of the assets being
dispersed of, determined without regard
to any liabilities associated with such
assets. This A–29 applies in any situ-
anation other than one involving the
transfer of stock (or issuance of stock)
in a parent corporation and stock in
such corporation remains outstanding
after the transaction. Thus, this A–29
applies to the sale of stock in a sub-
sidiary (when that subsidiary is treated
as a single corporation with the parent
pursuant to Q/A–46) and to mergers in-
volving the creation of a new corpora-
tion or with respect to the corporation
that is not surviving entity.

(b) (1) There is no change in owner-
ship or control under this A–29 when
there is a transfer to an entity that is
controlled by the shareholders of the
transferring corporation immediately
after the transfer, as provided in this
paragraph (b). A transfer of assets by a
corporation is not treated as a change
in the ownership of such assets if the
assets are transferred to—
(i) A shareholder of the corporation
(immediately before the asset transfer)
in exchange for or with respect to its
stock;
(ii) An entity, 50 percent or more of
the total value or voting power of
which is owned, directly or indirectly,
by the corporation;
(iii) A person, or more than one per-
son acting as a group, that owns, di-
rectly or indirectly, 50 percent or more
of the total value or voting power of all
the outstanding stock of the corpora-
tion;
or
(iv) An entity, at least 50 percent of
the total value or voting power is
owned, directly or indirectly, by a per-
son described in paragraph (b)(1)(iii)
of this A–29.

(2) For purposes of paragraph (b) and
except as otherwise provided, a per-
son’s status is determined immediately
after the transfer of the assets. For ex-
ample, a transfer to a corporation in
which the transferor corporation has
no ownership interest in before the
transaction, but which is a majority-
owned subsidiary of the transferor
corporation after the transaction is not
treated as a change in the ownership of
the assets of the transferor corpora-
tion.

(c) For purposes of this A–29, persons
will not be considered to be acting as
a group merely because they happen to
purchase assets of the same corpora-
tion at the same time, or as a result of
the same public offering. However, per-
sons will be considered to be acting as
a group if they are owners of a corpora-
tion that enters into a merger, consoli-
dation, purchase or acquisition of as-
sets, or similar business transaction
with the corporation. If a person, in-
cluding an entity shareholder, owns
stock in both corporations that enter
into a merger, consolidation, purchase
or acquisition of stock, or similar
transaction, such shareholder is con-
sidered to be acting as a group with
other shareholders in a corporation
only to the extent of the ownership in
that corporation prior to the trans-
action giving rise to the change and
not with respect to the ownership in-
terest in the other corporation.

(d) For purposes of determining stock
ownership, see Q/A–27(c).

(e) The following examples illustrate
the principles of this A–29:

Example 1. Corporation M acquires assets
having a gross fair market value of $500,000
from Corporation N (an unrelated corpora-
tion) on January 1, 2006. The total gross fair
market value of Corporation N’s assets im-
mediately prior to the acquisition was $3
million. Since the value of the assets ac-
quired by Corporation M is less than one-
third of the total gross fair market value of
Corporation N’s total assets immediately
prior to the acquisition, the acquisition does
not represent a change in the ownership of a
substantial portion of Corporation N’s as-
sets.

Example 2. Assume the same facts as in Ex-
ample 1. Also assume that on November 1,
2006, Corporation M acquires from Corpora-
tion N additional assets having a fair market
value of $700,000. Thus, Corporation M has ac-
quired from Corporation N assets worth a
total of $1.2 million during the 12-month pe-
riod ending on November 1, 2006. Since $1.2
million is more than one-third of the total
such payments are parachute payments? To determine whether such payments are parachute payments, they must be tested against the individual’s base amount (as defined in Q/A–34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual’s base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual’s base amount, no portion of the payment is a parachute payment. See Q/A–31, Q/A–32, and Q/A–33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A–37 of this section for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A–30:

Example 1. A is a disqualified individual with respect to Corporation M. A’s base amount is $100,000. Payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M totaling $400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A’s base amount of $100,000 (3($100,000)=$300,000).

Example 2. Assume the same facts as in Example 1, except that the payments contingent on the change in the ownership or control of Corporation M total $200,000. Because the payments do not have an aggregate present value at least equal to 3 times A’s base amount, no portion of the payments is a parachute payment.

Q-31: As of what date is the present value of a payment determined?

A–31: (a) Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

Three-Times-Base-Amount Test for Parachute Payments

Q-30: Are all payments that are in the nature of compensation, made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A–30: (a) No. To determine whether such payments are parachute payments, they must be tested against the individual’s base amount (as defined in Q/A–34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual’s base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual’s base amount, no portion of the payment is a parachute payment. See Q/A–31, Q/A–32, and Q/A–33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A–37 of this section for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A–30:

Example 1. A is a disqualified individual with respect to Corporation M. A’s base amount is $100,000. Payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M totaling $400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A’s base amount of $100,000 (3($100,000)=$300,000).

Example 2. Assume the same facts as in Example 1, except that the payments contingent on the change in the ownership or control of Corporation M total $200,000. Because the payments do not have an aggregate present value at least equal to 3 times A’s base amount, no portion of the payments is a parachute payment.
(b)(1) For purposes of determining whether a payment is a parachute payment, if a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the change in ownership or control, the value of the payment is the present value of such payment (or payments) calculated in accordance with Q/A–32 of this section and based on reasonable actuarial assumptions.

(2) If the payment in the nature of compensation is an obligation to provide health care, then for purposes of this A–31 and for applying the 3-times-base-amount test under Q/A–30 of this section, the present value of such obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A–30 and this A–31, the obligation to provide health care is permitted to be measured by projecting the cost of premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums.

Q–32: What discount rate is to be used to determine present value?

A–32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined, using the period until the payment would have been made without regard to the change in ownership or control as the term of the debt instrument under section 1274(d). See Q/A–24 and 31 of this section. However, for any payment, the corporation and the disqualified individual may elect to use the applicable Federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q–33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A–33: (a) In certain cases, it may be necessary to apply the 3-times-base-amount test of Q/A–30 of this section, or to allocate a portion of the base amount to a payment described in paragraphs (a)(1), (2), and (3) of Q/A–2 of this section, at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual’s right to receive a payment may be contingent on the involuntary termination of such individual’s employment with the corporation. In such a case, it must be reasonably estimated whether the payment will be made. If it is reasonably estimated that there is a 50-percent or greater probability that the payment will be made, the full amount of the payment is considered for purposes of the 3-times-base-amount test and the allocation of the base amount. Conversely, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose.

(b) If the estimate made under paragraph (a) of this A–33 is later determined to be incorrect, the 3-times-base-amount test described in Q/A–30 of this section must be reapplied (and the portion of the base amount allocated to previous payments must be reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base-amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A–31 of this section, using the discount rate described in A–32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. Alternatively, if, based on the application of the 3-times-base-amount test without regard to the payment described in paragraph (a) of this A–33, a disqualified individual is
determined to have an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in paragraph (a) of this A–33 is made (or becomes certain to be made) if no base amount is allocated to such payment.

(c) To the extent provided in published guidance of general applicability under §601.601(d)(2) of this Chapter, an initial estimate of the value of an option subject to Q/A–13 of this section is permitted to be made, with the valuation subsequently re-determined, and the 3-times-base-amount test reapplied.

(d) The following examples illustrate the principles of this A–33:

Example 1. A, a disqualified individual with respect to Corporation M, has a base amount of $100,000. Under A’s employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of $250,000 contingent on a change in ownership or control of Corporation M. In addition, the agreement provides that if A’s employment is terminated within 1 year after the change in ownership or control, A will receive an additional payment in the nature of compensation in the amount of $150,000, payable 1 year after the date of the change in ownership or control. A change in ownership or control of Corporation M occurs and A receives the first payment of $250,000. Corporation M reasonably estimates that there is a 50-percent probability that, as a result of the change, A’s employment will be terminated within 1 year after the date of the change. Corporation M must assume that the $150,000 payment will be made to A as a result of the change in ownership or control.

Example 2. Assume the same facts as in Example 1, except that Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A’s employment will be terminated within 1 year of the date of the change. Corporation M must assume that the $150,000 payment will not be made to A as a result of the change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation P, has a base amount of $300,000. Under B’s employment agreement with Corporation P, if there is a change in ownership or control of Corporation P, B will receive a severance payment of $600,000 and a bonus payment of $400,000. In addition, the agreement provides that if B’s employment is terminated within 1 year after the change, B will receive an additional payment in the nature of compensation of $500,000. A change in ownership or control of Corporation P occurs, and B receives the $600,000 and $400,000 payments. At the time of the change in ownership or control, Corporation P reasonably estimates that there is less than 50-percent probability that B’s employment will be terminated within 1 year of the change. For purposes of applying the 3-times-base-amount test, because Corporation P reasonably estimates that there is less than 50-percent probability that B’s employment will be terminated within 1 year of the change, Corporation P assumes that the $500,000 payment will not be made to B.

Eleven months after the change in ownership or control, B’s employment is terminated, and the $500,000 payment is made to B. Because B was determined to have excess parachute payments without regard to the $500,000 payment, the 3-times-base-amount test is not reapplied and the base amount is not reallocated to include the $500,000 payment. The entire $500,000 payment is treated as an excess parachute payment.

Q–34: What is the base amount?

A–34: (a) The base amount of a disqualified individual is the average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs (or for a predecessor entity or a related entity as defined in Q/A–21 of this section) which was includible in the gross income of such individual for taxable years in the base period (including amounts that were excluded under section 911), or which would have been includible in such gross income if such person had been a United States citizen or resident. See Q/A–35 of this section for the definition of base period and for examples of base amount computations.

(b) If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year,
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compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c) Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of excludible fringe benefits are not included in the base amount but may be treated as parachute payments.

(d) The base amount includes the amount of compensation included in income under section 83(b) during the base period. See Q/A–35 for the definition of base period.

(e) The following example illustrates the principles of this A–34:

Example. A disqualified individual, D, receives an annual salary of $500,000 per year during the 5-year base period. D defers $100,000 of D’s salary each year under the corporation’s nonqualified deferred compensation plan. D’s base amount is $400,000 ($400,000 × (5/5)).

Q–35: What is the base period?

A–35: (a) The base period of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. For this purpose, the date of the change in ownership or control is the date the corporation experiences one of the events described in Q/A–27, Q/A–28, or Q/A–29 of this section. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in Q/A–21 of this section) for this entire 5-year period, the individual’s base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b) The following examples illustrate the principles of Q/A–34 of this section and this Q/A–35:

Example 1. A disqualified individual, D, was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in ownership or control of the corporation occurs. D’s includible compensation income from the corporation was $30,000 for the 4-month period, $120,000 for the first full year, and $150,000 for the second full year. D’s base amount is $120,000, (120,000 × $400,000) + $125,000 × $150,000 = $120,000 + $150,000) / 3.

Example 2. Assume the same facts as in Example 1, except that D also received a $60,000 signing bonus when D’s employment with the corporation commenced at the beginning of the 4-month period. D’s base amount is $140,000, ($60,000 + (3 × $39,000)) + $120,000 + $150,000 / 3. Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing D’s compensation for the 4-month period.

Example 3. E is a disqualified individual with respect to Corporation X who was not an employee or independent contractor for the full 5-year base period. In 2004 and 2005, E is a director of X and receives $30,000 per year for E’s services. In 2006, E becomes an officer of X. E’s includible compensation from Corporation X is $250,000 for 2006 and 2007, and $300,000 for 2008. In 2006, X undergoes a change in ownership or control. E’s base amount is $140,000 (2 × $250,000) + (2 × $30,000) / 4).

Q–36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in Q/A–21 of this section), prior to the individual’s taxable year in which the change in ownership or control occurs?

A–36: (a) In such a case, the individual’s base amount is the annualized compensation for services performed for the corporation (or a predecessor entity or related entity) which—

(1) Was includible in the individual’s gross income for that portion, prior to such change, of the individual’s taxable year in which the change occurred (including amounts that were excluded under section 911), or would have been includible in such gross income if such person had been a United States citizen or resident;

(2) Was not contingent on the change in ownership or control; and

(3) Was not a securities violation parachute payment.
(b) The following examples illustrate the principles of this A–36:

Example 1. On January 1, 2006, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in Q/A–21 of this section). Under the employment contract, A is to receive an annual salary of $120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A’s employment is terminated without cause. On July 1, 2006, after A has received compensation of $60,000, a change in the ownership or control of Corporation M occurs. Because of the change, A’s employment is terminated without cause, and he receives a payment of $420,000. It is established by clear and convincing evidence that the $60,000 in compensation is not contingent on the change in ownership or control, but the presumption that the $420,000 payment is contingent on the change is not rebutted. Thus, the payment of $420,000 is treated as contingent on the change in ownership or control of Corporation M. In this case, A’s base amount is $120,000 (2 × $60,000). Since the present value of the payment which is contingent on the change in ownership of Corporation M ($420,000) is more than 3 times A’s base amount of $120,000 (3 × $120,000 = $360,000), the payment is a parachute payment.

Example 2. Assume the same facts as in Example 1, except that A also receives a signing bonus of $50,000 from Corporation M on January 1, 2006. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership or control. When the change in ownership or control occurs on July 1, 2006, A has received compensation of $110,000 (the $50,000 bonus plus $60,000 in salary). In this case, A’s base amount is $170,000 ($50,000 + (2 × $60,000)). Because the $50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A’s compensation. The present value of the potential parachute payment ($420,000) is less than 3 times A’s base amount of $170,000 (3 × $170,000 = $510,000), and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q–37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A–37: (a) No, the term parachute payment also includes any payment (other than a payment exempted under Q/A–6 or Q/A–8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is a securities violation payment. A securities violation payment is a payment made or to be made—

(1) Pursuant to an agreement that violates any generally enforced Federal or state securities laws or regulations; and

(2) In connection with a potential or actual change in ownership or control.

(b) A violation is not taken into account under paragraph (a)(1) of this A–37 if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A–37 are referred to in this section as securities violation payments.

(c) Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A–22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A–30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual (and are included in allocating base amount under Q/A–38 of this section). Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.
(d) The rules in paragraph (b) of this A–37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and were reduced by, or did not include, any applicable amount of reasonable compensation).

(e) The following examples illustrate the principles of this A–37:

Example 1. A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A’s base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A’s base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A’s total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A’s base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A–37, the amount of A’s total excess parachute payments is 0.5 times A’s base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example 2. Assume the same facts as in Example 1, except that the present value of the first payment is equal to 2 times A’s base amount. If the second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A’s base amount, and the amount of A’s total excess parachute payments is 2.5 times A’s base amount. If the second payment is treated as a securities violation parachute payment, the amount of A’s total excess parachute payments is 0.5 times A’s base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B’s base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B’s base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the first payment is reasonable compensation for personal services to be rendered after the change in ownership or control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of parachute payment pursuant to Q-A-9 of this section. Thus, the amount of B’s total excess parachute payment is zero because the present value of the second payment does not equal or exceed 3 times B’s base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B’s total excess parachute payments is 3 times B’s base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example 4. Assume the same facts as in Example 3, except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B’s excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B’s excess parachute payment is 3 times B’s base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q-38: How is the amount of an excess parachute payment computed?

A-38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual’s base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is the excess parachute payment computed
payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. See Q/A–31, Q/A–32, and Q/A–33 of this section for rules on determining present value and Q/A–34 of this section for the definition of base amount.

(b) The following example illustrates the principles of this A–39:

Example. An individual with a base amount of $100,000 is entitled to receive two parachute payments of $200,000 and the other of $400,000. The $200,000 payment is made at the time of the change in ownership or control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 ($400,000/$500,000 × $100,000) and $60,000 ($300,000/$500,000 × $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 – $40,000) and that of the second is $340,000 ($400,000 – $60,000).

Q–39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A–39: (a) Generally, yes. Except in the case of payments treated as securities violation parachute payments or when the portion of a payment that is treated as contingent on the change in ownership or control is determined under paragraph (b) or (c) of Q/A–24 of this section, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (for example, because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are exempt from the definition of parachute payment under Q/A–6 through Q/A–9 of this section) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion of the disqualified individual’s base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b) The following examples illustrate the principles of this A–39:

Example 1. Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of the individual’s base amount that is allocated to the parachute payment is $100,000. Also assume that $300,000 of the $600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000 – $100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation ($300,000) is first reduced by the portion of the disqualified individual’s base amount that is allocated to the parachute payment ($100,000), and the remainder ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced by $200,000 of reasonable compensation.

Example 2. Assume the same facts as in Example 1, except that the full amount of the $600,000 parachute payment is established as reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q–40: How is it determined whether payments are reasonable compensation?

A–40: (a) In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following—
(1) The nature of the services rendered or to be rendered;
(2) The individual’s historic compensation for performing such services; and
(3) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

(b) For purposes of section 280G, reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete).

Q–41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services?

A–41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in Q/A–26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or are to be rendered on or after, the date of the change in ownership or control. Q/A–46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A–41. No determination of reasonable compensation is needed for payments under qualified plans to be exempt from the definition of parachute payment under Q/A–8 of this section.

Q–42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A–42: (a) Yes, if payments are made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing of the following generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of the change in ownership or control—

(1) The payments were made or are to be made only for the period the individual actually performs such personal services; and
(2) If the individual’s duties and responsibilities are substantially the same after the change in ownership or control, the individual’s annual compensation for such services is not significantly greater than such individual’s annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual’s duties and responsibilities are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services. However, except as provided in paragraph (b) and (c) of this A–42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services contemplated in exchange for the compensation.

(b) Generally, an agreement under which the disqualified individual must refrain from performing services (e.g., a covenant not to compete) is an agreement for the performance of personal services for purposes of this A–42 to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual’s ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence, payments under the agreement are treated as severance payments under Q/A–44 of this section.

(c) If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for breach of contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control—


(1) The contract was not entered into, amended, or renewed in contemplation of the change in ownership or control;
(2) The compensation the individual would have received under the contract would have qualified as reasonable compensation under section 162;
(3) The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;
(4) The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer (including involuntary termination or constructive discharge); and
(5) The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual’s earned income (within the meaning of section 891(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. See Q/A–44 of this section for rules regarding damages for a failure to make severance payments.
(d) The following examples illustrate the principles of this A–42:

Example 1. A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for $100,000 for the first year of the contract and, for each succeeding year, an annual salary that is 10 percent higher than the prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A’s services by entering into an employment contract with A that is essentially the same as A’s contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M’s obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than A’s prior year’s salary. Amounts are payable under the contract only for the portion of the term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are not exempt from the definition of parachute payment pursuant to Q/A–9 of this section.

Example 2. Assume the same facts as in Example 1, except that A does not perform the services described in the new contract, but receives payment under the new contract. Because services were not rendered after the change, the payments under this contract are not exempt from the definition of parachute payment pursuant to Q/A–9 of this section.

Example 3. Assume the same facts as in Example 1, except that under the new contract A agrees to perform consulting services to Corporation N, when and if Corporation N requires A’s services. Assume further that when Corporation N does not require A’s services, the contract provides that A must not perform services for any other competing company. Corporation N previously enforced similar contracts against former employees of Corporation N. Because A is substantially constrained under this contract and Corporation N is reasonably likely to enforce the contract against A, the agreement is an agreement for the performance of services under paragraph (b) of this A–42. Assuming the requirements of paragraph (a) of this A–42 are met and there is clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership, the payments under this contract are exempt from the definition of parachute payment pursuant to Q/A–9 of this section.

Example 4. Assume the same facts as in Example 1, except that instead of agreeing not to compete with Corporation N, under the new agreement A agrees not to disparage either Corporation M or Corporation N. Because the nondisparagement agreement does not substantially constrain A’s ability to perform services, no amount of the payments under this contract are reasonable compensation for the nondisparagement agreement.

Example 5. Assume the same facts as in Example 1, except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A’s request to remain employed by Corporation N, A’s employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the
present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the amount received by A is exempt from the definition of parachute payment pursuant to Q/A–9 of this section.

Q–43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A–43: Yes, payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q–44: May severance payments be treated as reasonable compensation?

A–44: (a) No, severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term severance payment means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual’s employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual on the termination of such individual’s employment, whenever occurring.

(b) The following example illustrates the principles of this A–44:

Example. A, a disqualified individual, has a three-year employment contract with Corporation X. Under the contract, A will receive a salary of $200,000 for the first year of the contract, and for each succeeding year, an annual salary that is $100,000 higher than the previous year. In the event of A’s termination of employment following a change in ownership or control, the contract provides that A will receive the remaining salary due under the employment contract. At the beginning of the second year of the contract, Corporation Y acquires all of the stock of Corporation X. A’s employment is terminated, and A receives $700,000 ($300,000 for the second year of the contract plus $400,000 for the third year of the contract) representing the remaining salary due under the employment contract. Because the $700,000 payment is treated as a severance payment, it is not reasonable compensation for personal services on or after the date of the change in ownership or control. Thus, the full amount of the $700,000 is a parachute payment.

Miscellaneous Rules

Q–45: How is the term corporation defined?

A–45: For purposes of this section, the term corporation has the meaning prescribed by section 7701(a)(3) and §301.7701–2(b) of this Chapter. For example, a corporation, for purposes of this section, includes a publicly traded partnership treated as a corporation under section 7704(a); an entity described in §301.7701–3(c)(1)(v)(A) of this Chapter; a real estate investment trust under section 856(a); a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation as defined under section 7701(a)(5).

Q–46: How is an affiliated group treated?

A–46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A–6; Q/A–7 of this section (except as provided therein)), payor of parachute payments (Q/A–10 of this section), disqualified individuals (Q/A–15 through Q/A–21 of this section (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A–26 of this section (except
as provide therein), change in ownership or control (Q–A–27, 28, and 29 of this section), and reasonable compensation (Q–A–42, 43, and 44 of this section).

Effective Date

Q–47: What is the general effective date of section 280G?

A–47: (a) Generally, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is treated as a new contract entered into on the day the renewal takes effect.

(b) For purposes of paragraph (a) of this A–47, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(c) Section 280G applies to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a supplement to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

(d)(1) Except as otherwise provided in paragraph (e) of this A–47, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control (parachute provisions), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented—

(i) To add or modify, to the disqualified individual’s benefit, a change in ownership or control trigger;

(ii) To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual’s advantage); or

(iii) To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

(2) For purposes of paragraph (a) of this A–47, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

(e) A contract entered into on or before June 14, 1984, is not treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following—

(1) The length of time between the adjustment and the change in ownership or control;

(2) The extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate;

(3) A comparison of the adjustment with historical practices of the corporation;

(4) The extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts; and

(5) The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q–48: What is the effective date of this section?

A–48: This section applies to any payments that are contingent on a change in ownership or control if the change in ownership or control occurs on or after
January 1, 2004. Taxpayers may rely on these regulations after August 4, 2003, for the treatment of any parachute payment.


§ 1.280H–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 280H.

§ 1.280H–1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

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[T.D. 8205, 53 FR 19711, May 27, 1988]

§ 1.280H–1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

(a) Introduction. This section applies to any taxable year that a personal service corporation has a section 444 election in effect (an “applicable election year”). For purposes of this section, the term personal service corporation has the same meaning given such term in §1.441–3(c).

(b) Limitation on certain deductions of personal service corporations—(1) In general. If, for any applicable election year, a personal service corporation does not satisfy the minimum distribution requirement in paragraph (c) of this section, the deduction otherwise allowable under chapter 1 of the Internal Revenue Code of 1986 (the Code) for applicable amounts, as defined in paragraph (b)(4) of this section, shall not exceed the maximum deductible amount, as defined in paragraph (d) of this section.

(2) Carryover of nondeductible amounts. Any amount not allowed as a deduction in an applicable election year under paragraph (b)(1) of this section shall be allowed as a deduction in the succeeding taxable year.

(3) Disallowance inapplicable for certain purposes. The disallowance of deductions under paragraph (b)(1) of this section shall not apply for purposes of subchapter G of chapter 1 of the Code (relating to corporations used to avoid income tax on shareholders) nor for determining whether the compensation of employee-owners is reasonable. Thus, for example, in determining whether a personal service corporation is subject to the accumulated earnings tax imposed by section 531, deductions disallowed under paragraph (b)(1) of this section are treated as allowed in computing accumulated taxable income.

(4) Definition of applicable amount—(i) In general. For purposes of section 280H and the regulations thereunder, the term applicable amount means, with respect to a taxable year, any amount
that is otherwise deductible by a personal service corporation in such year and includable at any time, directly or indirectly, in the gross income of a taxpayer that during such year is an employee-owner. Thus, an amount includable in the gross income of an employee-owner will be considered an applicable amount even though such employee owns no stock of the corporation on the date the employee includes the amount in income. See Example 1 in paragraph (b)(4)(ii) of this section.

(ii) Special rule for certain indirect payments. For purposes of paragraph (b)(4)(i) of this section, amounts are indirectly includable in the gross income of an employee-owner of a personal service corporation that has made a section 444 election (an electing personal service corporation) if the amount is includable in the gross income of—

(A) The spouse (other than a spouse who is legally separated from the partner or shareholder under a decree of divorce or separate maintenance) or child (under age 14) of such employee-owner, or

(B) A corporation more than 50 percent (measured by fair market value) of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners), of the electing personal service corporation, or

(C) A partnership more than 50 percent of the profits and capital of which is owned by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners) of the electing personal service corporation, or

(D) A trust more than 50 percent of the beneficial ownership of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to any such employee-owners), of the electing personal service corporation.

For purposes of this paragraph (b)(4)(ii), ownership by any person described in this paragraph (b)(4)(ii) shall be treated as ownership by the employee-owners of the electing personal service corporation. Paragraph (b)(4)(ii)(B) of this section will not apply if the corporation has made a section 444 election to use the same taxable year as that of the electing personal service corporation. Similarly, paragraph (b)(4)(ii)(C) of this section will not apply if the partnership has made a section 444 election to use the same taxable year as that of the electing personal service corporation. Notwithstanding the general effective date provision of paragraph (f) of this section, this paragraph (b)(4)(ii) is effective for amounts deductible on or after June 1, 1988.

(iii) Example. The provisions of paragraph (b)(4) of this section may be illustrated by the following examples.

Example 1. A is an employee of P, an accrual basis personal service corporation with a taxable year ending September 30. P makes a section 444 election for its taxable year beginning October 1, 1987. On October 1, 1987, A owns no stock of P; however, on March 31, 1988, A acquires 10 of the 200 outstanding shares of P stock. During the period October 1, 1987 to March 31, 1988, A earned $40,000 of compensation as an employee of P. During the period April 1, 1988 to September 30, 1988, A earned $60,000 of compensation as an employee-owner of P. If paragraph (b) of this section does not apply, P would deduct for its taxable year ended September 30, 1988 the $100,000 otherwise deductible amount is considered an applicable amount under this section.

Example 2. I1 and I2, calendar year individuals, are employees of PSC1, a personal service corporation that has historically used a calendar year, and is an employee, of PSC2, a calendar year personal service corporation. For its taxable years beginning February 1, 1987, 1988, and 1989, PSC1 has a section 444 election in effect to use a January 31 taxable year. During its taxable years beginning February 1, 1986, 1987, and 1988, PSC1 deducted $10,000, $11,000, and $12,000, respectively, that was included in PSC2’s gross income. Furthermore, of the $12,000 deducted by PSC1 for its taxable year ending February 1, 1988, $7,000 was deducted during the period June 1, 1987 to January 31, 1989. Pursuant to paragraph (b)(4)(ii)(B) of this section, the $7,000 deducted by PSC1 on or after June 1, 1988, and included in PSC2’s gross income is considered an applicable amount for PSC1’s taxable year beginning February 1, 1988. Amounts deducted by PSC1 prior to June 1, 1988, are not subject to paragraph (b)(4)(ii)(B) of this section.

Example 3. The facts are the same as in Example 2, except that for its taxable years beginning February 1, 1987, 1988, and 1989, PSC2 has a section 444 election in effect to use a taxable year ending September 30. During its taxable years beginning February 1, 1986, 1987, and 1988, PSC2 deducted $10,000, $11,000, and $12,000, respectively, of compensation that was included in PSC1’s gross income. Furthermore, of the $12,000 deducted by PSC2 for its taxable year ending February 1, 1988, $7,000 was deducted during the period June 1, 1987 to January 31, 1989. Pursuant to paragraph (b)(4)(ii)(B) of this section, the $7,000 deducted by PSC2 on or after June 1, 1988, and included in PSC1’s gross income is considered an applicable amount for PSC2’s taxable year beginning February 1, 1988.
January 31 taxable year. Since both PSC1 and PSC2 have the same taxable year and both have section 444 elections in effect, paragraph (b)(4)(ii)(B) of this section does not apply to the $7,000 deducted by PSC1 for its taxable year beginning February 1, 1988.

(c) Minimum distribution requirement—(1) Determination of whether requirement satisfied—(i) In general. A personal service corporation meets the minimum distribution requirement of this paragraph (c) for an applicable election year if, during the deferral period of such applicable election year, the applicable amounts (determined without regard to paragraph (b)(2) of this section) for all employee-owners in the aggregate equal or exceed the lesser of—

(A) The amount determined under the “preceding year test” (see paragraph (c)(2) of this section), or

(B) The amount determined under the “3-year average test” (see paragraph (c)(3) of this section).

The following example illustrates the application of this paragraph (c)(1)(i).

Example. Q, an accrual-basis personal service corporation, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. Q has 4 employee-owners, B, C, D, and E. For Q’s applicable election year beginning February 1, 1987 and ending January 31, 1988, B earns $6,000 a month plus a $45,000 bonus on January 15, 1988; C earns $5,000 a month plus a $40,000 bonus on January 15, 1988; D and E each earn $4,500 a month plus a $40,000 bonus on January 15, 1988. Q meets the minimum distribution requirement for such applicable election year if the applicable amounts during the deferral period (i.e., $220,000) equal or exceed the amount determined under the preceding year test or the 3-year average test.

(ii) Employee-owner defined. For purposes of section 280H and the regulations thereunder, a person is an employee-owner of a corporation for a taxable year if—

(A) On any day of the corporation’s taxable year, the person is an employee of the corporation or performs personal services for or on behalf of the corporation, even if the legal form of that person’s relationship to the corporation is that of an independent contractor, and

(B) On any day of the corporation’s taxable year, the person owns any outstanding stock of the corporation.

(2) Preceding year test—(1) In general. The amount determined under the preceding year test is the product of—

(A) The applicable amounts during the taxable year preceding the applicable election year (the “preceding taxable year’’), divided by the number of months (but not less than one) in the preceding taxable year, multiplied by

(B) The number of months in the deferral period of the applicable election year.

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

Example. R, a personal service corporation, has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, R makes a section 444 election to retain its January 31 taxable year. R is an accrual basis taxpayer and has one employee-owner, F. For R’s taxable year ending January 31, 1987, F earns $5,000 a month plus a $40,000 bonus on January 15, 1987. The amount determined under the preceding year test for R’s applicable election year beginning February 1, 1987 is $91,667 ($100,000, the applicable amounts during R’s taxable year ending January 31, 1987, divided by 12, the number of months in R’s taxable year ending January 31, 1987, multiplied by 11, the number of months in R’s deferral period for such year).

(3) 3-year average test—(1) In general. The amount determined under the 3-year average test is the applicable percentage multiplied by the adjusted taxable income for the deferral period of the applicable election year.

(ii) Applicable percentage. The term applicable percentage means the percentage (not in excess of 95 percent) determined by dividing—

(A) The applicable amounts during the 3 taxable years of the corporation (or, if fewer, the taxable years the corporation has been in existence) immediately preceding the applicable election year, by

(B) The adjusted taxable income of such corporation for such 3 taxable years (or, if fewer, the taxable years of existence).

(iii) Adjusted taxable income—(A) In general. The term adjusted taxable income means taxable income determined without regard to applicable amounts.

(B) Determination of adjusted taxable income for the deferral period of the applicable election year. Adjusted taxable
Example 1. S is a personal service corporation that has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, S makes a section 444 election to retain its taxable year ending January 31. S does not satisfy the minimum distribution requirement for its first applicable election year, and the applicable amounts for that year exceed the maximum deductible amount by $54,000. Under paragraph (b)(2) of this section, the $54,000 excess is carried over to S's taxable year beginning February 1, 1988. Furthermore, if S continues its section 444 election for its taxable year beginning February 1, 1988, and desires to use the 5-year average test provided in this paragraph for such year, pursuant to paragraph (c)(3)(iii)(A) of this section the $54,000 will not be allowed to reduce adjusted taxable income for such year. See also section 280H(e) regarding the disallowance of net operating loss carrybacks to (or from) any taxable year of a corporation personal service election under section 444 applies.

Example 2. T is a personal service corporation with a section 444 election in effect, is determining whether it satisfies the 3-year average test for its second applicable election year. T had a net operating loss (NOL) for its first applicable election year of $45,000. The NOL resulted from $150,000 of gross income less the sum of $95,000 of salary, $45,000 of other expenses, and $54,000 of deductible applicable amounts. Pursuant to paragraph (c)(3)(iii)(C) of this section, the entire amount of the $45,000 NOL is attributable to applicable amounts since the applicable amounts deducted in arriving at the NOL (i.e., $54,000) were greater than the NOL (i.e., $45,000). Thus, for purposes of computing the adjusted taxable income for the deferral period of T's second applicable election year, the NOL carryover to that year is $0 ($45,000 NOL less $45,000 amount of NOL attributable to applicable amounts).

(d) Maximum deductible amount—(1) In general. For purposes of this section, the term maximum deductible amount means the sum of—

(i) The applicable amounts during the deferral period of the applicable election year, plus

(ii) An amount equal to the product of—

(A) The amount determined under paragraph (d)(1)(i) of this section divided by the number of months in the deferral period of the applicable election year, multiplied by

(B) The number of months in the nondeferral period of the applicable election year. For purposes of the preceding sentence, the term nondeferral period means the portion of the applicable election year that occurs after the portion of such year constituting the deferral period.

(2) Example. The provisions of paragraph (d)(1) of this section may be illustrated by the following example.

Example. U, an accrual basis personal service corporation with a taxable year ending January 31, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. For its applicable election year beginning February 1, 1987, U does not satisfy the minimum distribution requirement in paragraph (c) of this section. Furthermore, U has 3 employee-owners, G, H, and I. G and H have been employee-owners of U for 10 years. Although I has been an employee of U for 4 years, I did not become an employee-owner until December 1, 1987, when I acquired 5 of the 20 outstanding shares of U stock. For U's applicable election year beginning February 1, 1987, G earns $5,000 a month plus a $40,000 bonus on January 15, 1988, and H and I each earn $4,000 a month plus a $32,000 bonus on January 15, 1988. Thus, the total of the applicable
amounts during the deferral period of the applicable election year beginning February 1, 1987 is $143,000. Based on these facts, U’s deduction for applicable amounts is limited to $156,000, determined as follows—$143,000 (applicable amounts during the deferral period) plus $13,000 (applicable amounts during the deferral period, divided by the number of months in the deferral period, multiplied by the number of months in the nondeferral period).

(e) Special rules and definition—(1) Newly organized personal service corporations. A personal service corporation is deemed to satisfy the preceding year test and the 3-year average test for the first year of the corporation’s existence.

(2) Existing corporations that become personal service corporations. If an existing corporation becomes a personal service corporation and makes a section 444 election, the determination of whether the corporation satisfies the preceding year test and the 3-year average test is made by treating the corporation as though it were a personal service corporation for each of the 3 years preceding the applicable election year.

(3) Disallowance of NOL carryback. No net operating loss carryback shall be allowed to (or from) any applicable election year of a personal service corporation.

(4) Deferral period. For purposes of section 280H and the regulations thereunder, the term deferral period has the same meaning as under \(1.444-1T(b)(4)\).

(5) Examples. The provisions of this paragraph (e) may be illustrated by the following examples.

Example 1. V is a personal service corporation with a taxable year ending September 30. V makes a section 444 election for its taxable year beginning October 1, 1987, and incurs a net operating loss (NOL) for such year. Because an NOL is not allowed to be carried back from an applicable election year, V may not carry back the NOL from its first applicable election year to reduce its 1985, 1986, or 1987 taxable income.

Example 2. W, a personal service corporation, commences operations on July 1, 1990. Furthermore, for its taxable year beginning July 1, 1990, W makes a section 444 election to use a year ending September 30. Pursuant to paragraph (e)(1) of this section, W satisfies the preceding year test and the 3-year average test for its first year in existence. Thus, W may deduct, without limitation under this section, any applicable amounts for its taxable year beginning July 1, 1990.

Example 3. The facts are the same as in Example 2. For its taxable year beginning October 1, 1990, W incurs an NOL and is not a personal service corporation. Furthermore, W desires to carry back the NOL to its preceding taxable year (a year that was an applicable election year). Pursuant to paragraph (e)(3) of this section, W may not carry back an NOL “to” its taxable year beginning July 1, and ending September 30, 1990, because such year was an applicable election year.

(f) Effective date. The provisions of this section are effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19711, May 27, 1988]

TAXABLE YEARS BEGINNING PRIOR TO JANUARY 1, 1986

§ 1.274–5A Substantiation requirements.

(a) In general. No deduction shall be allowed for any expenditure with respect to:

(1) Traveling away from home (including meals and lodging) deductible under section 162 or 212.

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e), or

(3) Gifts defined in section 274, unless the taxpayer substantiates such expenditure as provided in paragraph (c) of this section. This limitation supersedes with respect to any such expenditure the doctrine of Cohan v. Commissioner (C.C.A. 2d 1930) 39 F. 2d 540. The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expense but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction shall be allowed a taxpayer for such expenditures on the basis of such approximations or unsupported testimony of the taxpayer. For purposes of this section, the term entertainment means entertainment, amusement, or recreation, and use of a facility therefore; and the